

# CLASS ACTIONS AND RULE 10b-5: A CRITIQUE OF *NEWTON V. MERRILL LYNCH*

## I. INTRODUCTION

It is generally presumed that when one hires an agent for a particular task, that agent will use reasonable efforts to carry out the task in a manner that maximizes the benefit to the principal.<sup>1</sup> This presumption becomes particularly important in situations in which the principal does not have the specialized knowledge necessary to carry out the task. In few places is this as clear as in the investment industry, an industry that, by its nature, requires that the principal has the ability to police the agent in order to be certain that the agent satisfies this standard. Absent the power to police agents, principals are vulnerable, and agents have less incentive to carry out tasks properly. In the investment context, this policing power is distributed to both governmental agencies and private actors.<sup>2</sup> However, the rapid development of technology combined with the industry's complexity makes policing agents very difficult. To date, the United States Securities and Exchange Commission ("SEC") has done a commendable job adapting to technological change.<sup>3</sup> Yet from the

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1. Restatement (Second) of Agency § 424 (1958). "[A]n agent employed to buy or to sell is subject to the principal . . . to be loyal to the principal's interests and to use reasonable care to obtain terms which best satisfy the manifested purpose of the principal." *Id.* (quoted in Ferrell, *infra* note 18).

2. See *infra* notes 43-44 and accompanying text.

3. The SEC and Congress have responded to changes in technology in a variety of ways throughout history. For instance, they created the National Association of Securities Dealers ("NASD") and the National Association of Securities Dealers Automated Quotation System ("NASDAQ") in order to exploit innovation. *In re Merrill Lynch; Securities Litig.*, 911 F. Supp. 754, 758 (D.N.J. 1995) ("*Merrill Lynch I*"). More recently, the Small Order Exchange System ("SOES") and NAcqess provide examples of the SEC's willingness to accommodate technological change. *Id.* at 759-60. Furthermore, in addition to the creation of systems, the SEC has adapted to technological changes by requiring the use of the best technology available:

The scope of this duty of best execution must evolve as changes occur in the market that give rise to improved executions for customer orders, including opportunities to trade at more advantageous prices. As these changes occur, broker-dealers' procedures for seeking to obtain best execution for customer orders also must be modified to consider price opportunities that become "reasonably available".

*Newton v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 135 F.3d 266, 271 n.3 (3d Cir. 1998) (en banc), *cert. denied sub nom. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Kravitz*, 525 U.S. 811 (1998) (quoting Accord Order Execution Obligations, Exchange Act Release No. 37,619A, 61 Fed. Reg. 48290, 48322-23 (Sept. 12, 1996)) ("*Newton I*"). The duty of best execution has clearly evolved over time. NIMMER, INFORMATION LAW, ¶ 10.10 (1996). For further discussion of the duty of best execution, see *infra* notes 87-105 and accompanying text. For a discussion of new proposals, see Report of the SEC Advisory Committee on Market Information: Blueprint for Responsible Change (2001), available at <http://www.sec.gov/divisions/marketreg/marketinfo/finalreport.html>. See also Joel

principal's perspective, it remains difficult to assure that an agent sought out the most favorable deal. When individuals suffer relatively small damages, class action suits become one important method of policing agents<sup>4</sup> because they reduce the cost of the litigation for each individual and make it affordable to assert claims.

In *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,<sup>5</sup> the Third Circuit Court of Appeals shut the door on a potential class action, thereby impeding the individual class members' ability to protect themselves. In *Newton*, thousands of plaintiffs sought certification for a class action against three broker-dealer firms.<sup>6</sup> The plaintiffs claimed that the broker-dealers did not disclose their failure to satisfy the duty of best execution,<sup>7</sup> and thus violated § 10(b) of the Securities Exchange Act of 1934 ("the '34 Act")<sup>8</sup> and Rule 10b-5<sup>9</sup> promulgated thereunder. Essentially, the plaintiffs argued that the broker-dealers<sup>10</sup> failed to disclose that they would not take advantage of readily available technology which offered potentially superior deals, and thus violated the '34 Act.<sup>11</sup> After battles in the district and appeals courts, the Third Circuit held that because the class could not prove an injury on a class-wide basis, Federal Rule of Civil Procedure 23(b)(3)<sup>12</sup> class certification was inappropriate.<sup>13</sup>

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Seligman, *Rethinking Securities Markets: The SEC Advisory Committee on Market Information and the Future of the National Market System*, 57 BUS. LAW 637 (2002).

4. See *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797 (1985). See also Brian Wolfman, *Forward: National Association of Consumer Advocates' Standards and Guidelines for Litigating and Settling Class Actions*, 176 F.R.D. 370 (1998); Arthur R. Miller, *Of Frankenstein Monsters and Shining Knights: Myth, Reality, and the "Class Action Problem,"* 92 HARV. L. REV. 664 (1979).

5. The *Newton* case traveled up and down the Third Circuit over several years. The district court first ruled, granting summary judgment for the defendants on the basis that there was no proof of "reliance" on a "material misrepresentation," elements necessary for a Rule 10b-5 claim. *Merrill Lynch I*, 911 F. Supp. 754 (D.N.J. 1995). The case then went to the Third Circuit Court of Appeals. *Newton I*, 135 F.3d 266. The Third Circuit overruled the district court and extended the presumption of reliance from *Basic v. Levinson*. See 485 U.S. 224 (1988). On remand, the district court again ruled against the plaintiffs. *In re Merrill Lynch Sec. Litig.*, 191 F.R.D. 391 (D.N.J. 1999) ("*Merrill Lynch II*"). This time, the district court refused to certify the proposed class. The case was again appealed to the Third Circuit Court of Appeals. *Newton v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 259 F.3d 154 (3d Cir. 2001), *amended by* *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154 (3d Cir. October 16, 2001) ("*Newton II*"). For clarity, this Note will refer to the district court decisions as "*Merrill I*" and "*Merrill II*" and the appellate decisions as "*Newton I*" and "*Newton II*," and to the case as a whole as "*Newton*."

6. The firms included Merrill Lynch, Pierce, Fenner & Smith, Inc., Painewebber, Inc., and Dean Witter Reynolds, Inc.

7. *Newton II*, 259 F.3d at 173.

8. 15 U.S.C. § 78j (2000).

9. 17 C.F.R. § 240.10b-5 (2001).

10. A "broker-dealer" performs specific activities. See *infra* notes 89-90.

11. For an extensive discussion of plaintiffs' claim, see *Merrill Lynch I*, 911 F. Supp. at 756-58.

12. FED. R. CIV. P. 23(b)(3) (1998) [hereinafter Rule 23(b)(3)].

As the dust settles from the Third Circuit's decision, it is unclear what effect the decision will have on the enforcement of the securities laws. This Note argues that the *Newton* decision serves to reduce private enforcement of Rule 10b-5 by constraining class actions. Although *Newton* recognizes that the defendants may have violated Rule 10b-5,<sup>14</sup> it refuses to remove impediments to the proposed class and therefore significantly limits class actions as a means of private enforcement.<sup>15</sup> Therefore, this Note argues that the decision will affect principals' ability to feel secure that their agents are obtaining the best terms for their trades.<sup>16</sup>

This Note analyzes the decisions in *Newton* with an eye toward the evolution of the '34 Act and Rule 10b-5. Because this is a recent decision,<sup>17</sup> commentators have not had much time to digest it.<sup>18</sup> But given the attention to the first *Newton* opinion, this decision is likely to receive a good deal of scrutiny. This Note anticipates some areas of discussion and concludes that the Third Circuit could have, and should have, certified the class for at least a portion of the litigation.

Part II addresses the context and history of the *Newton* decisions and introduces the crucial concepts behind the plaintiffs' theory. It first provides a brief overview of the securities markets in general, and the "over-the-counter" market in particular. Second, it discusses the applicable regulatory framework as well as the duty of best execution and the requisite elements of a prima facie 10b-5 case. Third, it describes the applicable certification requirements under the Federal Rules of Civil Procedure. Finally, it traces the history of *Newton* from the district court through the most recent Third Circuit decision.

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13. *Newton II*, 259 F.3d at 181.

14. *Newton I*, 135 F.3d at 274.

15. 259 F.3d at 154. Because litigation is expensive and plaintiffs individually lost relatively small amounts, the pooling of costs via a class action represents the only cost-effective means of pressing these claims, unless a single individual lost a substantial amount. *See infra* note 29.

16. This does not negate the possibility of SEC enforcement, but the SEC has not involved itself in this case. Also, without class action, the utility of liability as a means to pressure the industry to use technology in fulfilling the duty of best execution is diminished.

17. The decision in *Newton II* was released on August 6, 2001 and amended on October 16, 2001. For some early commentary on the decision, see Seligman, *supra* note 3, at 651-52; *Denial of Class Certification Affirmed in Suit Against Brokers*, 7 No. 2 ANDREWS SEC. LITIG. & REG. REP. 3 (2001).

18. The decision in *Newton I* received much attention. *See, e.g.,* NIMMER, *supra* note 3, at ¶ 10.10 [3]; Allen Ferrell, *A Proposal for Solving the "Payment for Order Flow" Problem*, 74 S. CAL. L. REV. 1027 (2001).

Part III discusses the decisions of the district court and the Third Circuit throughout the case. It notes some differences between the two appellate decisions as well as between the district court and the Third Circuit. The main focus, however, is on the Third Circuit's rationale for affirming the denial of certification.

Part IV critically analyzes the most recent *Newton* decision. It uncovers logical inconsistencies within *Newton II* and argues that the decision poorly reflects the spirit of the '34 Act.

Finally, Part V provides an alternative to the Third Circuit's approach. It suggests that the class could have been certified under Rule 23(b)(3) for some, if not all, of the litigation. It concludes that, because class action is needed to facilitate private enforcement of the '34 Act, certification should be granted in such cases.

Parties enforcing the '34 Act and Rule 10b-5 should not tolerate the activities alleged in *Newton*.<sup>19</sup> Even though the analysis of the Third Circuit may be reasonable, the end result limits private enforcement.

## II. THE HISTORY OF *NEWTON*, § 10(b), RULE 10b-5, AND CERTIFICATION UNDER 23(b)(3)

The securities industry is a complex web of markets. The plaintiffs in *Newton* were investors in a particular segment of the market: the “over-the-counter” market (“OTC”).<sup>20</sup> Plaintiffs engaged defendants as broker-dealers to execute their trades under the assumption that the defendants would fulfill their obligations arising out of that agency relationship.<sup>21</sup> Plaintiffs contended that defendants failed to meet those obligations, specifically the duty of best execution, without proper disclosure, and therefore violated § 10(b) of the '34 Act and Rule 10b-5.<sup>22</sup> The following briefly describes (1) the history of the *Newton* case,<sup>23</sup> (2) the securities markets in general and the “over-the-counter” market in particular,<sup>24</sup> (3) § 10(b) and Rule 10b-5 and the elements of a prima facie case under those regulations,<sup>25</sup> (4) the common law and regulatory obligations of the duty

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19. The major harm arising out of the alleged activities is to the market's integrity. If the claims are true, they should give investors pause because there is very little that can be done to supervise their agents. Given that integrity is arguably the market's most valuable asset, the '34 Act aims to protect it. *See infra* notes 69-85 and accompanying text.

20. *See infra* notes 40-68 and accompanying text.

21. *See infra* notes 86-104 and accompanying text.

22. *Newton II*, 259 F.3d at 173.

23. *See infra* notes 28-39 and accompanying text.

24. *See infra* notes 40-68 and accompanying text.

25. *See infra* notes 69-85 and accompanying text.

of best execution,<sup>26</sup> and (5) the requirements for class certification under Federal Rule of Civil Procedure 23(b)(3).<sup>27</sup>

#### A. History of *Newton*

The proposed class in *Newton* represented thousands of clients of three major broker-dealer firms who purchased or sold securities during the period from November 4, 1992 until November 4, 1996 (“the class period”).<sup>28</sup> During this period, there were hundreds of millions of transactions involving billions of dollars affecting members of the class.<sup>29</sup> The class alleged that each of the broker-dealers accepted the clients’ orders with the intention of only executing those transactions on the NBBO<sup>30</sup> and *not even considering* alternate services or methods of execution<sup>31</sup> to determine if a superior deal could be obtained.<sup>32</sup> Plaintiffs claimed that this was a violation of the broker-dealers’ duty of best execution,<sup>33</sup> and therefore the failure to notify the client of their intentions prior to accepting the order amounted to a “material misrepresentation” in violation of Rule 10b-5.<sup>34</sup>

Initially, the case was brought in the United States District Court for the District of New Jersey and dismissed on summary judgment for lack of a “material misrepresentation” and “reliance.”<sup>35</sup> On appeal, after an initial hearing and then a rehearing en banc, the Third Circuit held that the plaintiffs did state a valid claim under Rule 10b-5.<sup>36</sup> The court found that there could have been a material misrepresentation and extended a “presumption of reliance” on that misstatement.<sup>37</sup> On remand, the district court struck down the plaintiffs’ case again by refusing to certify the class on the grounds that it failed to meet the requirements of Federal Rules of

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26. See *infra* notes 86-104 and accompanying text.

27. See *infra* notes 105-20 and accompanying text.

28. 191 F.R.D. at 393.

29. 259 F.3d at 187. Although the sheer dollar amount is astonishing, the transactions were spread out over a large class. In addition, the difference between the prices offered by the alternative systems was small. Thus, the actual loss per client was relatively small. A study conducted for the district court revealed that the largest damage amount associated with for any one trade was twenty-five dollars. *Merrill Lynch I*, 911 F. Supp. at 764-67.

30. See *supra* notes 44-68 and accompanying text.

31. See *supra* notes 55-68 and accompanying text.

32. *Merrill Lynch I*, 911 F. Supp. at 757-58.

33. See *supra* notes 87-105 and accompanying text.

34. *Merrill Lynch I*, 911 F. Supp. at 757-58.

35. *Id.* at 754.

36. *Newton I*, 135 F.3d 274.

37. *Id.*

Civil Procedure 23(a) and 23(b)(3).<sup>38</sup> Plaintiffs again appealed to the Third Circuit. This time, a panel of the Third Circuit, while disagreeing with some of the district court's analysis, upheld the denial of certification based on its finding that the proposed class failed to meet the requirements of Federal Rule of Civil Procedure 23(b)(3).<sup>39</sup>

### *B. The Securities Markets and the "Over-the-Counter" Market*

The securities markets are a complex array of institutions that involve numerous types of instruments and trading systems.<sup>40</sup> The diversity of players and instruments in the securities industry make it both the backbone of the U.S. economy<sup>41</sup> and the focal point of a complex regime of interconnected systems and regulations.<sup>42</sup> These regulations include both common law rules of agency as well as institutionally imposed restrictions on behavior.<sup>43</sup>

*Newton* involved a specific segment of the securities market: the "over-the-counter" market ("OTC"). Major marketplaces, such as the New York Stock Exchange ("NYSE") or the American Stock Exchange ("AMEX"), provide a "floor" for negotiations and transactions of securities.<sup>44</sup> In the OTC, negotiations and transactions occur outside of the traditional "floor" setting.<sup>45</sup> The National Association of Securities Dealers ("NASD")

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38. *Merrill Lynch II*, 191 F.R.D. 391.

39. *Newton II*, 259 F.3d at 192.

40. For a general discussion of the markets, see POSER, *BROKER-DEALER LAW AND REGULATION* § 1.01 (3d ed. 1999).

41. POSER, *supra* 40, at § 1.01, at 1-5 (listing the relative dollar values of different components of the securities industry) (citing *Board of Governors of the Federal Reserve System, Flow of Funds Accounts of the United States: Flows and Outstandings Fourth Quarter 1998* at 69-81 (Sept. 15, 2000)). But Poser also notes:

because of the central role played by brokers and dealers in raising capital, directing the savings of millions of individual investors, facilitating mergers and acquisitions, and making secondary markets in securities, the relative amount of financial assets that they hold gives an inadequate picture of the importance of these firms in the economy. Broker-dealer firms played a key role in the dynamic stock market of the late 1990s and early 2000s, which has enabled the U.S. economy "to reallocate resources on a large scale from traditional industries to new high-growth sectors linked to [information technology] and the Internet."

*Id.* (citing David Hale, *Rebuilt by Wall Street*, FIN. TIMES, Jan. 25, 2000).

42. POSER, *supra* note 40 § 1.01, at 1-4-1-5. This complex system of regulations requirements that broker-dealers register with the SEC under § 5 of the Securities Act of 1933, become members of the NASD (although some broker-dealers do not have to be NASD members), register with one of the stock exchanges, which in turn, has its own set of rules and regulations, and follow the rules and regulations imposed by the applicable state commissions (the so-called "Blue Sky" laws). *Id.*

43. *Id.* See also *supra* notes 86-95 and accompanying text.

44. On the "floor," individual negotiators, or "specialists," meet to negotiate and transact securities deals face-to-face. *Newton I*, 135 F.3d at 268.

45. Unlike the NYSE or AMEX, the OTC has no "floor." Rather, the OTC "is, in a sense, the

governs the activities of the OTC and is itself subject to the oversight of the SEC.<sup>46</sup> In 1971, Congress created the National Association of Securities Dealers Automated Quotation System (“NASDAQ”),<sup>47</sup> a subsidiary of the NASD. NASDAQ is Congress’s attempt to respond to technological change and harness it to enhance the efficiency of securities transactions.<sup>48</sup> NASDAQ links OTC dealers across the country via a computer system.<sup>49</sup> All participants in the NASDAQ are required to list their current “bid” and “ask” prices<sup>50</sup> on the National Best Bid Best Offer (“NBBO”) system.<sup>51</sup> The NBBO, in turn, processes the information provided by the broker-dealers across the country and lists the best bid and ask prices.<sup>52</sup> Thus, when a broker-dealer wishes to execute a trade, she looks to the NBBO to find the best prices submitted by all of the other broker-dealers in the country. This system greatly enhances both the efficiency of the market as well as the diversity of the participants by creating immediate nation-wide access to the system.<sup>53</sup>

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oldest and simplest type of economic exchange: buyer and seller meet outside a formal marketplace, agree on a price and exchange items of economic value.” *Merrill Lynch I*, 911 F. Supp. at 758 (citing *Reshaping The Equity Markets*, Robert A. Schwartz at 47 (HarperBusiness 1991)).

46. *Newton I*, 135 F.3d at 268.

47. *Merrill Lynch I*, 911 F. Supp. at 758 (citing 15 U.S.C. § 78k-l(a)(1)(A) and (D) (2000)).

48. *Id.* The Court noted that Congress made the purpose of NASDAQ explicit:

The securities markets are an important national asset which must be preserved and strengthened . . . . The linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors’ orders, and contribute to best execution of such orders.

*Id.*

49. Thus, broker-dealers in Cincinnati or Philadelphia can quickly and easily execute electronic trades with broker-dealers in Boston or Chicago without the need for a “floor” or face-to-face interaction. *Merrill Lynch I*, 911 F. Supp. at 758. *See also* POSER, *supra* note 40.

50. A “bid” price is the price at which a security may be purchased (i.e., the price at which another market-maker is willing to sell their security). The “ask” price is the price at which a security can be sold (i.e., the price at which another market-maker is willing to buy the security). The difference between the “bid” and the “ask” prices is the “spread.” *Merrill Lynch I*, 911 F. Supp. at 758-59. “In order to ‘foster the risk-taking function of market makers and thereby . . . provide free market incentives to active participation in the flow of orders . . .’ market makers are allowed to capture the spread as their profit. *Id.* at 758 (citing Securities Acts Amendments of 1975, Report of the Committee on Banking, Housing and Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. at 12 (1975); *Plastis v. E.F. Hutton*, No. G86-1030CA5, 1990 U.S. Dist. LEXIS 4828 (W.D. Mich. 1990); *Investors Research Corp.*, 1976 SEC LEXIS 2771 (1976)).

51. *Id.* at 759 (citing 17 C.F.R. § 240.11Ac1-1(c)(1) (2000)).

52. *Id.* (citing 17 C.F.R. § 240.11Ac1-1(a)(10), 17 C.F.R. § 240.11Ac1-1(c)(2) (2000)).

53. Rather than funneling all trades to the floor, where face-to-face negotiations occur, the NBBO gives the broker-dealer instantaneous access to the best bid and best ask prices currently listed. No negotiations are necessary. Rather, with the click of one, or perhaps two, buttons the order is immediately executed.

Today, however, changes in technology have facilitated alternatives to the NBBO, and therefore the prices listed on the NBBO may not always be the best prices available to the broker-dealer.<sup>54</sup> Beginning in November of 1990, SelectNet offered an alternative to the NBBO.<sup>55</sup> In addition to SelectNet, Institutional Networks, Inc. (“Instinet”) provides another list of prices that can differ from the NBBO.<sup>56</sup> There are distinctions between the NBBO, SelectNet, and Instinet that might make a particular system more or less attractive to a broker-dealer.<sup>57</sup> For purposes of this Note, the distinctions are themselves largely irrelevant, but that they exist is not.<sup>58</sup> Rather, there are two critical aspects of the three systems that relate to the *Newton* case. First, the listings offered by SelectNet and Instinet *can* be different from the NBBO and therefore they might be superior or inferior to the NBBO.<sup>59</sup> Indeed, *Newton I* cites one study indicating that

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54. Plaintiffs contended that defendants ignored internet sources such as Instinet and SelectNet, as well as several other avenues by which trades could have been executed at superior prices. *Merrill I*, 911 F. Supp. at 757-58. Additionally, plaintiffs alleged that defendants participated in “payment for order flow” schemes in which the brokers to whom the plaintiffs’ trades were given did not achieve the best execution for the trade. *Id.* at 758.

55. The district court described SelectNet as follows:

SelectNet is an on-line service provided by NASDAQ on which subscribers can negotiate trades and execute orders in OTC securities. In addition to price, offers posted by subscribers can specify size, the period during which the offer is “open,” (any period up to 99 minutes or an entire day), and whether the price or size of an order is negotiable. Subscribers may also “preference” their orders, that is, an order may be directed at a specific market maker, at all market makers, or at all subscribers. Offers may be accepted, countered or declined. Subscribers who are not market makers may make their offers anonymously. Market makers must identify themselves.

The thrust of the SelectNet service is to provide an electronic alternative to negotiation by telephone. “The system is offered to NASD members to facilitate negotiation of securities transactions through computer automation, rather than relying on telephone communication.”

*Id.* at 759 (quoting Market 2000, An Examination of Current Equity Market Developments, Division of Market Regulation of the SEC, Section IV at 6-7, 1994 SEC LEXIS 135 (1994)).

56. The district court described Instinet as:

another on-line trading system, similar to SelectNet but differing in two important aspects: 1) it is privately owned and operated; and 2) subscribers, including market makers, may display offers and trade *anonymously*. Traders, particularly large institutions, may therefore conduct large transactions without any revelation of their identity that might induce market reaction against their interest. Orders are accepted from a minimum of 1000 shares to a maximum of 50,000 shares. Although it conducts trades on behalf of clients, Instinet is not a market maker and therefore does not risk its own capital, charging only a commission for its services.

*Id.* (citing Instinet Corp., SEC No-Action Letter, 1992 WL 672345) (emphasis in original).

57. For instance, differences in identification requirements, the time limits or size restrictions, might have an effect on the decision to use the NBBO, SelectNet, or Instinet.

58. This is for a couple of reasons. First, the courts assume that all investors are interested only in economic gain. *Newton I*, 135 F.3d at 271. Second, if the economic considerations are important, then the defendants’ policy of uniform methods of execution makes no sense, regardless of what the differences may be.

59. *Merrill Lynch I*, 911 F. Supp. at 759-60.



approximately eighty-five percent of the bids displayed on Instinet and ninety percent of the bids on SelectNet were superior to the publicly posted NASDAQ prices.<sup>60</sup> Second, because they are internet-based, broker-dealers have easy access to the systems.<sup>61</sup> These two components of the NBBO alternatives became the crux of the dispute in *Newton*.<sup>62</sup>

In addition to Instinet and SelectNet, plaintiffs alleged that there were numerous other methods by which the defendants could have executed their trades.<sup>63</sup> Plaintiffs contended that defendants could have simply “crossed” offers to buy and sell within their own institution to achieve a price “between the quotes.”<sup>64</sup> They also argued that the firms could have used the Small Order Execution System (“SOES”)<sup>65</sup> whereby smaller transactions could occur at the NBBO prices when it might otherwise have been difficult to execute such trades at the NBBO price levels.<sup>66</sup> In all, plaintiffs claimed that there were at least four methods readily available to

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60. *Newton I*, 135 F.3d at 272.

61. To access these systems, one only needs an online computer and perhaps an account with the system. There should be little question that these firms either had or could easily obtain access. Indeed, plaintiffs even claimed that “defendants regularly used these services and knew that prices better than NBBO were often available through them.” *Newton I*, 135 F.3d at 269. Plaintiffs even accused defendants of re-trading on those systems for their own profit. *Merrill Lynch I*, 911 F. Supp. at 758.

62. The price differential offers the basis for the argument that the broker-dealers’ systematic failure to look at the non-NBBO services violated the duty of best execution. Simply put, the plaintiffs claimed that because there are easily accessible alternatives to the NBBO that could conceivably offer superior prices, the failure to utilize or even consider those systems as a potential source of liquidity constituted a failure to meet the duty of best execution. *Newton I*, 135 F.3d at 269.

63. *Merrill Lynch I*, 911 F. Supp. at 757-58.

64. *Id.* at 760. The district court described “crossing” as follows:

Individual integrated firms, functioning as either agents or principals, receive orders to both buy and sell securities in the course of the trading day. When either a limit or market order is received before a “corresponding” order is executed, the possibility exists that the two orders could be matched, or “crossed” at a price midway between them. “Call market” trading systems employed in some foreign countries, e.g., Austria, Belgium, Germany and Israel, as opposed to “continuous” trading systems employed on the United States financial markets (both securities exchanges and the OTC markets), regularly utilize this type of order crossing by periodically batching corresponding offers for simultaneous execution at a single “clearing” price . . . .

*Id.* at 760.

65. The district court described the SOES in *Merrill Lynch I* as:

In response to the general sentiment that retail customers were not obtaining execution at the best possible price, the SEC created [the SOES] in December, 1984. Participation in SOES was made mandatory for market makers after the October 1987 crash . . . . Automatic execution on SOES provides small customers with the opportunity to consistently obtain the NBBO by automatically routing orders to the market maker with the best posted bid or offer.

*Merrill Lynch I* at 759-60. The opinion goes on to describe the 1989 introduction of the Limit-Order Service as an extension of the SOES. *Id.* at 760.

66. *Merrill Lynch I*, 911 F. Supp. at 757.

the defendants to obtain prices superior to the NBBO.<sup>67</sup> The crucial assertion was that the alternatives (1) offered a potentially better price and (2) were easily available. Because of the failure to even consider these alternatives, or as plaintiffs alleged, re-trading on those alternate services for their own profit, plaintiffs claimed that the broker-dealers did not obtain trades on the terms most favorable to their clients.<sup>68</sup>

### C. Section 10(b) and Rule 10b-5

During the 1930s, in the wake of the stock market crash and in the midst of the Great Depression, Congress drastically altered the federal government's involvement in the securities industry.<sup>69</sup> Popular sentiment shifted from the support for unregulated markets to an increased demand for government oversight.<sup>70</sup>

As part of the '34 Act, § 10(b) aimed to protect the integrity of the securities markets. The stock market crash demonstrated the importance of investor confidence and Congress recognized the need to protect the integrity of the markets in order to make them function properly.<sup>71</sup> In part, Congress chose § 10(b) to achieve precisely that end.<sup>72</sup>

Under the authority granted to the SEC by § 10(b), the SEC adopted Rule 10b-5.<sup>73</sup> The SEC, in response to a particular instance of fraud that

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67. *Id.* at 758. In arguably the most serious of the allegations, the plaintiffs claimed that the defendants "re-traded" securities on the same side of the spread (in other words, purchased or sold a security at the NBBO when a better price was available and then performed the same transaction again at the superior price) in order to capture the additional profit for themselves. *Merrill Lynch I*, 911 F. Supp. at 758.

68. *Id.* at 757-58.

69. In a series of Congressional and Executive actions, the federal government changed its traditional policy and began to vigorously regulate economic activity. The Securities Act of 1933 and the Securities Exchange Act of 1934 are two such examples.

70. For a detailed history of the '34 Act, see Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385 (1990). See also, John H. Walsh, *A Simple Code of Ethics: A History of the Moral Purpose Inspiring Federal Regulation of the Securities Industry*, 29 HOFSTRA L. REV. 1015 (2001).

71. *Id.*

72. § 10(b) states, in pertinent part, that it is unlawful:

[t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe.

*Newton I*, 259 F.3d at 173 (quoting 15 U.S.C. § 78(b) (1934)).

73. Rule 10b-5 states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to

did not appear to be covered by the then-existing regulations, drafted and passed the broad-sweeping Rule 10b-5 with virtually no discussion.<sup>74</sup>

The '34 Act in general, and Rule 10b-5 in particular, provide a cause of action for fraud “in connection with the purchase or sale of a security.”<sup>75</sup> The Third Circuit restated the elements of a Rule 10b-5 claim in *Newton I*, holding that in order to state a claim under Rule 10b-5, plaintiffs must demonstrate a material misrepresentation or omission, made with scienter, that is relied upon by the plaintiffs to their detriment.<sup>76</sup> Yet *Newton II* made clear that “[a] broker-dealer who ‘accepts such an order while intending to breach [the duty of best execution] makes a misrepresentation that is material to the purchase or sale of a security . . . . If the order was executed in a manner inconsistent with this duty, it was also performed with scienter.’”<sup>77</sup>

The Third Circuit’s decision came on the heels of the Supreme Court’s ruling in *Basic v. Levinson*<sup>78</sup> that significantly liberalized Rule 10b-5 litigation. In *Basic*, the class of investors who had sold stock brought a claim against the issuing company arguing that it had traded on the basis of a material misrepresentation.<sup>79</sup> Defendants asserted that the class as a whole could not provide class-wide proof of reliance and therefore should not be certified under Rule 23.<sup>80</sup> The Court nevertheless accepted a

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make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5. For a history of Rule 10b-5, see *ABA Sec. of Corp., Banking & Business Law*, Conference on the Federal Securities Laws, 22 BUS. LAW. 793, 921-23 (1967).

74. For the interesting story behind the drafting and passage of Rule 10b-5, see *ABA Sec. of Corp., Banking & Bus. Law*, *supra* note 73, at 921-23.

75. The private cause of action under Rule 10b-5 is now engrained in U.S. securities jurisprudence and “constitutes an essential tool for enforcement of the 1934 Act’s requirements.” *Basic v. Levinson*, 485 U.S. 224, 231 (1988) (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976) and *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975)).

76. 135 F.3d at 270 (citing *Sowell v. Butcher & Singer, Inc.*, 926 F.2d 289 (3d Cir. 1991)). The Supreme Court has created or articulated these requirements over time in a series of cases. *Basic*, 485 U.S. at 231 (citing *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977) (describing the “manipulative or deceptive” requirement); *Blue Chip Stamps*, 421 U.S. 723, (outlining the “in connection with purchase or sale” requirement); *Dirks v. SEC*, 463 U.S. 646 (1983) (describing the duty to disclose); *Chiarella v. U.S.*, 445 U.S. 222 (1980); *Ernst & Ernst*, 425 U.S. at 193 (discussing scienter)).

77. *Newton II*, 259 F.3d at 173-74.

78. 485 U.S. 224 (1988).

79. *Basic*, 485 U.S. at 228-29. The plaintiffs allege that *Basic, Inc.* made certain public statements that misstated the company’s position with respect to merger negotiations. *Id.* Plaintiffs contend that, because of the misstatements, the price at which they sold their shares was artificially depressed. *Id.*

80. *Id.* at 242.

presumption of reliance in order to certify the class.<sup>81</sup> It noted that the evolution of the securities industry required securities regulation to evolve also.<sup>82</sup> The Court went on to justify the presumption on the grounds of “fairness, public policy, and probability, as well as judicial economy.”<sup>83</sup> In particular, the Court explained that liberalizing Rule 10b-5 litigation was acceptable and necessary because it “[was] consistent with, and, *by facilitating Rule 10b-5 litigation, supports, the congressional policy embodied in the 1934 Act.*”<sup>84</sup> Thus, the Court relaxed the requirements of a Rule 10b-5 class action suit specifically to promote private enforcement.<sup>85</sup>

#### *D. Fiduciary Obligations and the Duty of Best Execution*

At its most basic level, the securities market is bifurcated into the primary and the secondary markets. The primary market essentially serves one purpose: to facilitate the generation of capital.<sup>86</sup> The secondary market, of which the NBBO is part, serves as a means of liquidity among investors, but also aids in the formation of capital.<sup>87</sup> Both markets bring groups together under a common set of rules, thereby making the

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81. *Id.* at 250. The Court reasoned that “[r]equiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented respondents from proceeding with a class action, since individual issues then would have overwhelmed the common ones.” Ultimately, the Court found the presumption necessary to facilitate Rule 10b-5 enforcement. *Id.* at 242. Because “[p]resumptions typically serve to assist courts in managing circumstances in which direct proof, for one reason or another, is rendered difficult,” extending the presumption of reliance was necessary. *Id.* at 245.

82. *Id.* at 243-44 (stating “our understanding of Rule 10b-5’s reliance requirement must encompass [the changes in the industry]”).

83. *Id.* at 245.

84. *Id.* (emphasis added).

85. Concededly, the *Basic* court justifies its decision, in part, on the basis of the “fraud on the market theory.” *Id.* at 241-42. The theory relies on the efficient market hypothesis, which claims that a stock’s price reflects the market’s evaluation of all public information about the company. As the Court described it:

The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company’s stock is determined by the available material information regarding the company and its business . . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements . . . . The causal connection between the defendants’ fraud and the plaintiffs’ purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.

485 U.S. at 241-42 (quoting *Peil v. Speiser*, 806 F.2d 1154, 1160-61 (3d Cir. 1986)). For further discussion of the efficient market hypothesis, see Eugene Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970). The plaintiffs’ case in *Newton* does not rely on the “fraud on the market” theory and therefore the *Basic* decision is not directly applicable.

86. POSER, *supra* note 40, at 1-5.

87. *Id.*

accumulation of capital vastly more efficient. Due to regulations, however, not everyone can buy or sell securities directly,<sup>88</sup> instead they must use an agent. Thus, would-be investors utilize professionals such as broker-dealers<sup>89</sup> to serve as “go betweens” in order to invest money into the market. Investors place their faith in the broker-dealer to act in their best interests.<sup>90</sup> This is virtually identical to the traditional agency relationship.<sup>91</sup> Indeed, there is a large amount of literature that argues that a broker-dealer assumes the fiduciary obligations for any client simply by virtue of the fact that the broker-dealer is in business.<sup>92</sup> Agency places upon the broker-

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88. *Id.* § 1.01.

89. “A ‘broker’ is a person (either an individual or a firm) engaged in the business of effecting securities transactions for others, and a ‘dealer’ is a person engaged in the regular business of buying and selling securities for his own account.” POSER, *supra* note 40, at § 1.01, pages 1-6. Furthermore, “since most firms act both as brokers and as dealers, they are usually referred to as broker-dealers.” *Id.* at 1-6, n.13 (citing SEC Ann. Rep. 27 (1999) (this Note will also refer to firms as broker-dealers)). But broker-dealers are “market makers” in that they provide their own money in order to assure liquidity. Thus, they can actually buy the security from their client and then sell the security on the market, capturing the spread between the prices and making a profit. However, the inflated spread that results from the selling of securities at sub-NBBO prices to capture the spread between NBBO and NBBO alternative prices (as is alleged by the plaintiffs) is not generally included in the ordinary spread that becomes the broker-dealer’s profit.

90. Because investors are not allowed to trade themselves and generally are not informed about the processes of the securities industry, they rely on the broker-dealer to act in their best interests to select the appropriate method and timing of execution. This has been analogized to the relationship between the buyer and real estate agent. Ferrell, *supra* note 18, at 1031-32. *See also infra* notes 87-105 and accompanying text. The NYSE and AMEX also require broker-dealers to abide by the duty of best execution. *See* NYSE Rule 123A, 2 N.Y.S.E. Guide (CCH) ¶ 2123A.41, at 2748 (adopted June 19, 1969) (“A broker handling a market order is to use due diligence to execute the order at the best price or prices available to him under the published market procedures of the Exchange.”); AMEX Rule 156(a), 2 Am. Stock Ex. Guide (CCH) ¶ 9296, at 2467-3 (adopted May 13, 1965) (same) (cited in Ferrell, *supra* note 18, at 1067 note 155.). Additionally, the NASD also requires that its brokers abide by the duty:

In any transaction for or with a customer, a member and persons associated with a member shall use reasonable diligence to ascertain the best inter-dealer market for the subject security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under the prevailing market conditions.

NASD Rules of Fair Practice, NASD Manual (CCH) ¶ 2151 at 2024 (adopted May 1, 1968) (quoted in Ferrell, *supra* note 18, at 1067 note 156). *See also* Hazen, 3 Law Sec. Reg. § 14.13 (4th ed.) (2001).

91. POSER, *supra* note 40, at § 2.01, pp. 2-3. *See also* Restatement (Second) of Agency § 424, *supra* note 1.

92. This is the so-called “shingle theory” of the relationship between the broker-dealer and the client. For commentary about the “shingle theory,” see HAZEN, *supra* note 90, at 14.15[3]. *See also* In the Matter of Richardt-Alyn & Co., Administrative Proceeding File No. 3-9099, 70 SEC Docket 1703, Release No. 10-151 (Sept. 30, 1999); Order Execution Obligations, 62 SEC Docket at 2242-44; Randal W. Quinn, *Déjà vu All Over Again: The SEC’s Return to Agency Theory in Regulating Broker-Dealers*, 1990 COLUM. BUS. L. REV. 61 (1990). Regardless, the parties agreed in *Newton* that the broker-dealer undertakes the order subject to the duty of best execution when they accept an order without price restrictions. *Merrill Lynch II*, 191 F.R.D. at 394.

dealer a tremendous fiduciary duty to the client,<sup>93</sup> especially given potential conflicts of interest peculiar to the broker-dealer.<sup>94</sup> Both the SEC and the judiciary have addressed the common law duties arising from agency in the investment context.<sup>95</sup>

These fiduciary obligations are essential to the securities markets. As one commentator explained, “the existence of the fiduciary principle is central to the health and viability of the financial markets.”<sup>96</sup> Because the client places such a tremendous amount of faith—and more importantly for the securities market, a tremendous amount of money—in the broker-dealer, she must be safeguarded by fiduciary principles. The existence of the fiduciary obligations to the client assures that her transactions will be conducted *solely* for her benefit, not the broker-dealer’s. This protection

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93. *Id.* As one commentator has described it,

[The broker-dealer] is held to rigorous duties of loyalty and care: [the broker-dealer] must avoid acts that put his interests in conflict with the beneficiary’s; his duties must be exercised with the utmost good faith and integrity; and he must employ such skill and judgment as might reasonably be expected of persons skilled in his calling.

POSER, *supra* note 40, at § 2.01 (citing Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 882 (1988)). *See also* Louis Loss, *The SEC and the Broker-Dealer*, 1 VAND. L. REV. 516, 522 (1948). Perhaps Judge Benjamin Cardozo articulated this standard most eloquently:

Many forms of conduct permissible in the workaday world for those acting at arm’s length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. *Not honesty alone, but the punctilio of an honor the most sensitive*, is then the standard of behavior. As to this there has developed a tradition that is *unbending and inveterate*. *Uncompromising rigidity* has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the “disintegrating erosion” of particular exceptions (citation omitted). Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

*Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. Div. 1928) (emphasis added). For further discussion of the duty of best execution, see Farrell, *supra* note 18, at 1066-70; Furey and Kiesewetter, *On-line Broker-Dealers: Conducting Compliance Reviews in Cyberspace*, 56 BUS. LAW. 1461, 1475-76 (2001); American Law Institute, American Bar Association Continuing Legal Education, *Trends in SEC Enforcement and Inspections of Investment Advisors*, SGO38 ALI-ABA 209, 233-34 (citing *In the Matter of Marc N. German*, File No. 3-9032 (Aug. 5, 1997); *In the Matter of Portfolio Management Consultants, Inc. and Kenneth S. Phillips*, Advisors Act Rel. No. 37376 (June 27, 1996); Public Proceedings Instituted Against Marc N. German, Advisors Act Rel. No. 1567 (June 27, 1996)). *See also* Tennenbaum v. Zeller, 552 F.2d 402, 411 (2d Cir. 1977); SEC Release 34-37619A, 61 Fed. Reg. 48290, 48322-23 (Sept. 12, 1996); *SEC Market 2000: An Examination of Current Equity Market Developments* (1994), available at 1994 SEC LEXIS 136; *In re E.F. Hutton & Co., Inc.*, Exchange Act Release No. 25,887, 41 SEC Docket (CCH) 413, 418 (July 6, 1988).

For a description of the duty arising out of the fiduciary relationship between the broker-dealer and the client, see *United States v. Dial*, 757 F.2d 163, 168 (7th Cir. 1985); *Magnum Corp. v. Lehman Brothers Kuhn Loeb, Inc.*, 794 F.2d 198, 200 (5th Cir. 1986).

94. The complexity of the OTC creates numerous possible conflicts of interest, such as the broker-dealer’s ability to capture the client’s profit by retrading.

95. *See supra* note 93. However, the SEC has never clearly defined the duty of best execution. Furey & Kiesewetter, *supra* note 93, at 1475.

96. POSER, *supra* note 40, at § 2.01, pages 2-4.

extends not only to whether the transaction is executed, but also to when and how it is executed. Thus, fiduciary obligations protect the invaluable integrity of the market.<sup>97</sup>

Among the duties owed to the client by the broker-dealer is the duty of best execution.<sup>98</sup> The duty of best execution is the assurance to the client that her interests are the sole motivation behind actions taken with her securities. Indeed, the duty of best execution has been called the “cornerstone of market integrity.”<sup>99</sup> Although the language used to articulate the duty varies, the essence of the duty is largely universal: reasonable efforts to execute the trade on the terms most advantageous to the client.<sup>100</sup> Judge Stapleton, writing the en banc opinion in *Newton I*, described the duty of best execution as follows:

The duty of best execution, which predates the federal securities laws, has its roots in the common law agency obligations of undivided loyalty and reasonable care that an agent owes to his principal. Since it is understood by all that the client-principal seeks

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97. The integrity of the markets is absolutely crucial to their proper function. The market must assure those who invest their money that it is legitimate or else they will not invest and the markets will fail. Not only does the integrity of the market aid investors in their initial investment, it also gives some degree of certainty to the system. Assuming that the efficient market hypothesis holds some weight, it is only when the market reacts to that information in a genuine, untainted manner that investors can truly understand the signals sent by the market and therefore invest with some degree of confidence. Thus, the market’s integrity serves these two, intimately intertwined functions: to entice investors by putting them at ease and to promote efficiency by allowing for some transparency in the market prices. It was this goal of protecting the legitimacy and integrity of the markets that motivated the passage of the securities acts in the 1930s. This goal remains the driving force behind securities jurisprudence today. See *supra* notes 70-86 and accompanying text. In the context of *Newton*, the market’s integrity is threatened because the investors are unaware of the higher costs they are paying due to the defendants’ policies. Yet, because Rule 10b-5 is a rule about disclosure, liability for a violation of the duty of best execution is removed if the broker-dealer discloses in advance his intention not to fulfill the duty. That, however, could create competitive pressures for the broker-dealer because clients might then migrate to broker-dealers who promise compliance with the duty.

98. There is some disagreement over whether the duty of best execution is truly a *fiduciary duty*. POSER, *supra* note 40, at § 2.03[B], pages 2-58 (noting that some jurisdictions do not consider the duty of best execution to be “of a fiduciary nature,” whereas others find that the duty arises from fiduciary obligations, which is also the opinion of the SEC) (citing *Index Futures Group v. Ross*, 557 N.E.2d 344 (Ill. App. Ct. 1990), *appeal denied*, 561 N.E.2d 557 (Ill. 1990); *Sinclair v. Securities and Exch. Comm.*, 444 F.2d 399, 400 (2d Cir. 1971); *First Union Brokerage v. Milos*, 717 F. Supp. 1519, 1526 (S.D. Fla. 1989) (citing *Gochnauer v. A.G. Edwards & Sons, Inc.*, 810 F.2d 1042, 1049 (11th Cir. 1987) and *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 953 (E.D. Mich. 1978), *aff’d*, 647 F.2d 165 (6th Cir. 1981); *Berki v. Renolds Sec., Inc.*, 560 P.2d 282, 286 (Or. 1977)).

99. DIV. OF MARKET REGULATION, U.S. SEC. & EXCH. COMM’N, *BEST EXECUTION IN MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS*, V-I (1994).

100. The duty of best execution can generally be divided into three component parts: “the duty to execute promptly; the duty to execute in the appropriate market; and the duty to obtain the best price.” POSER, *supra* note 40, § 2.03[B], at 2-58.

his own economic gain and the purpose of the agency is to help the client-principal achieve that objective, the broker-dealer, absent instructions to the contrary, is expected to use reasonable efforts to maximize the economic benefit to the client in each transaction.<sup>101</sup>

This duty exists regardless of whether the broker-dealer is acting as the agent or the principal.<sup>102</sup>

As noted in the Introduction, changes in technology create difficulties in determining whether a broker-dealer has fulfilled the duty of best execution.<sup>103</sup> The SEC has not made the principal's determination easier. Rather than expand the scope or clarity of the duty of best execution, the SEC has changed the mechanisms used in the system.<sup>104</sup>

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101. 135 F.3d at 270. However, other considerations are important in determining if a trade is executed in compliance with the duty of best execution. The en banc opinion expressly noted these additional considerations:

Other terms in addition to price are also relevant to best execution. In determining how to execute a client's order, a broker-dealer must take into account order size, trading characteristics of the security, speed of execution, clearing costs, and the cost and difficulty of executing an order in a particular market.

*Id.* at 270 n.2 (citing Payment for Order Flow, Exchange Act Release No. 33,026, 58 Fed. Reg. 52934, 52937-38 (Oct. 13, 1993)). But in so noting, the court relegated them to lesser importance. *Id.* As the passage from *Newton I* indicates, the Third Circuit reduced the duty of best execution in this case to the duty to find the most advantageous price for the client. *Id.* The court avoided discussing other considerations, indicating that:

When the plaintiffs state that better "prices" were reasonably available from sources other than the NBBO, we understand that to mean that, given an evaluation of price as well as all of the relevant terms, the trade would be better executed through a source of liquidity other than the NBBO (e.g. SelectNet, Instinet, in-house limit orders or market orders held by the defendants, or limit orders placed by the public in the Small Order Exchange System). Similarly, for convenience, we use the phrases "best reasonably available price" and "best terms" interchangeably.

*Id.* See also, Ferrell, *supra* note 18, at 1038; Furey and Kiesewetter, *supra* note 93, at 1475.

102. *Id.* See also *Merrill Lynch I*, 911 F. Supp. at 760 ("[the agency obligation] does not dissolve when the broker/dealer acts in its capacity as a principal"); In re: E.F. Hutton & Co., Securities Exchange Act Release No. 25887, [1988 Transfer Binder Fed. Sec. L. Rep. (CCH) ¶ 84,303 (1988)] ("a broker/dealer's determination to execute an order as a principal or agent cannot be 'a means by which the broker may elect whether or not the law will impose fiduciary standards upon him in the actual circumstances of any given relationship or transaction.'") (quoting *Opper v. Hancock Securities Corp.*, 250 F. Supp. 668, 675 (S.D.N.Y. 1966), *aff'd*, 367 F.2d 157 (2d Cir. 1966)).

103. See POSER, *supra* note 40, § 2.03[B], at 2-57.

104. The SEC has moved to alter the system in a variety of ways. See 17 C.F.R. §§ 240.11Ac1-1 to 1-4 (2000); Order Execution Obligations, Exchange Act Release No. 34-37619A, 61 Fed. Reg. 48290, 48306-16 (Sept. 12, 1996). However, these changes do not entirely address the issues of this case. At its most fundamental level, *Newton* asks how the client is to assure that the broker-dealer has fulfilled the duty of best execution when technological advances allow for potentially superior, reasonably available alternatives to the NBBO. While adjustments to the NBBO or changes in the systems that must be consulted can temporarily alleviate some of the confusion, the same issue arises again when a new technology becomes available. To expand the NBBO or to initiate NAqcess, although it might resolve the dispute for the particular set of facts, does not resolve the question for



### *E. The Requirements of Federal Rules of Civil Procedure 23(b)(3)*

In order to obtain certification for a class under Federal Rule of Civil Procedure 23, the proposed class must meet several requirements.<sup>105</sup> These requirements are divided into two categories. The first are the “prerequisites” for all classes under Rule 23(a).<sup>106</sup> Assuming a group satisfies those requirements, they then must meet one of three sets of requirements under Rule 23(b).<sup>107</sup> The plaintiffs in *Newton* moved for certification under Rule 23(b)(3).<sup>108</sup>

Under Rule 23(b)(3), a group must meet the “twin requirements of predominance and superiority.”<sup>109</sup> The Third Circuit described these requirements in *Newton II*, noting that:

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future developments. Moreover, the crucial issue in *Newton* is whether class actions should be used as a means of private enforcement of Rule 10b-5. The new regulations do not speak to the private enforcement issue or provide guidance as to the determination of individual damages in such cases. Finally, these particular plaintiffs allege defendants committed a harm against them. The SEC does not offer these plaintiffs a mechanism for retrospective relief. Not only would full adjudication of *Newton* not interfere with the regulatory scheme adopted by the SEC, it is the essentially *the only* mechanism available to plaintiffs seeking relief. Prohibiting plaintiffs from seeking private relief as a class stymies enforcement of Rule 10b-5 by effectively removing one crucial component of the enforcement scheme.

105. FED. R. CIV. P. 23(a) and (b) (1998).

106. FED. R. CIV. P. 23(a) provides:

Prerequisites to a Class Action. One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

107. FED. R. CIV. P. 23(b) provides for three categories of classes that may be maintained. 23(b)(1) allows for class certification if not certifying would subject the defendant to multiple suits that could produce multiple standards for judging their behavior. Rule 23(b)(2) allows for certification for suits aimed at injunctive or declaratory relief. Rule 23(b)(3) provides certification for class actions seeking damages in which the common questions for the class are such that joint litigation is deemed acceptable.

108. FED. R. CIV. P. 23(b)(3) provides:

Class Actions Maintainable. An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:

(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action.

109. *Newton II*, 259 F.3d at 186.

[t]he predominance inquiry demands “that questions of law or fact common to the members of the class predominate over any questions affecting only individual members” . . . . Superiority calls for a determination that a class action is the best method of achieving a “fair and efficient adjudication of the controversy.”<sup>110</sup>

This demands an analysis of the group that extends beyond the requirements of 23(a) and compels a “close look at the case before it is accepted as a class action.”<sup>111</sup> Furthermore, Rule 23(b)(3) offers several factors that weigh into the “close look,” such as the individual interests of each class member and the likely level of difficulty in managing the class.<sup>112</sup> As the Third Circuit noted in *In re Prudential Ins. Co. of Am. Sales Practice Litig.*,<sup>113</sup> “[I]ssues common to the class must predominate over individual issues, and the class action device must be superior to other means of handling the litigation.”<sup>114</sup>

The predominance inquiry measures whether the class is “sufficiently cohesive to warrant certification.”<sup>115</sup> The Third Circuit noted that this inquiry is more demanding than the commonality analysis in Rule 23(a) and requires “more than a common claim.”<sup>116</sup> Nonetheless, the Supreme Court’s suggestion that “predominance is a test *readily met* in certain cases alleging consumer or securities fraud or violations of the antitrust laws” should not go overlooked.<sup>117</sup>

The superiority analysis inquires into whether the litigation is best pursued as a class in terms of judicial efficiency.<sup>118</sup> This analysis fundamentally involves two questions, (1) will the proposed class be manageable;<sup>119</sup> and (2) will adjudicating the action as a class reduce the

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110. *Id.* (citing FED. R. CIV. P. 23(b)(3)).

111. *Newton II*, 259 F.3d at 186 (quoting *Georgine v. Amchem Prods., Inc.*, 83 F.3d 610, 615 (3d Cir. 1996)).

112. FED. R. CIV. P. 23(b)(3) lists the factors to be considered:

(A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of the class action.

*Newton II*, 259 F.3d at 186 (quoting FED. R. CIV. P. 23(b)(3)).

113. 148 F.3d 283 (3d Cir. 1998).

114. *Newton II*, 259 F.3d at 186-87 (quoting *In re Prudential Ins. Co. of Am. Sales Practices Litig.*, 148 F.3d at 313-14) (internal quotations omitted).

115. *Amchem Products, Inc. v. Windsor*, 521 U.S. 591, 623 (1997).

116. *Newton II*, 259 F.3d at 187.

117. *Amchem*, 521 U.S. at 625 (citing Comm. Note, FED R. CIV. P. 23) (emphasis added).

118. *Newton II*, 259 F.3d at 192.

119. *Id.* (citing *Amchem*, 521 U.S. at 620).

number of individual actions?<sup>120</sup>

With some context for the plaintiffs' claims and the requirements necessary to certify the class under Federal Rule of Civil Procedure 23(b)(3), this discussion now shifts to the court's analysis in *Newton*. Specifically, it examines how the Third Circuit pieced together the issues in *Newton II* as compared to the district court and its earlier analysis in *Newton I*.

### III. THE THIRD CIRCUIT'S ANALYSIS IN *NEWTON II*

Having essentially breathed life into an area of the law by extending the presumption of reliance for Rule 10b-5 claims in *Newton I*, the Third Circuit remanded the case to the district court.<sup>121</sup> Faced with a motion to certify the class under Rule 23(b)(3), the district court held that the suit was not fit for a class action.<sup>122</sup> On appeal, the panel in *Newton II*, although disagreeing with certain portions of the district court's analysis, generally upheld the lower court's denial.<sup>123</sup>

The en banc decision in *Newton I* provided the analytical framework for the district court.<sup>124</sup> In *Merrill I*, the district court initially held that the plaintiffs did not rely on a "material misrepresentation."<sup>125</sup> The *Newton I* court rejected this conclusion, holding that if the plaintiffs could prove their allegations, the failure to disclose could constitute a "material misrepresentation."<sup>126</sup> Furthermore, it extended the presumption of reliance to such cases like this one.<sup>127</sup> The circuit court then returned the case to the district court requiring that, in order to state a claim under Rule 10b-5, the class must prove:

- (1) a misrepresentation or omission of a material fact in connection with the purchase or sale of a security;
- (2) scienter on the part of the defendant;
- (3) reliance on the misrepresentation; and
- (4) damage resulting from the misrepresentation.<sup>128</sup>

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120. *Id.* (noting specifically that "we have recognized that adjudicating Rule 10b-5 securities claims as a class action satisfies superiority only if the litigation results in fewer individual actions").

121. *Newton I*, 135 F.3d 266.

122. *Merrill Lynch II*, 191 F.R.D. 391.

123. *Newton II*, 259 F.3d 154.

124. *Newton I*, 135 F.3d at 272-73.

125. *Merrill Lynch I*, 911 F. Supp. at 771-72.

126. *Newton I*, 135 F.3d at 272-73.

127. *Id.* at 266.

128. *Id.*

The district court turned to questions of reliance and damages to decide the plaintiffs' motion for 23(b)(3) class certification.<sup>129</sup>

The district court rejected the motion. First, relying on *Kyriazi v. W. Elec. Co.*,<sup>130</sup> the court held that “[c]ertification of a class under Rule 23 cannot relieve the individual class members from establishing each element of their claims.”<sup>131</sup> Then quoting from *Illinois v. Ampress Brick Co.*,<sup>132</sup> the court noted that “[t]he party seeking to represent a class must establish that all members of the purported class have suffered damages.”<sup>133</sup> Essentially, the district court held that, in order to be certified under Rule 23(b)(3), the purported class must establish via class-wide proof that each member of the class satisfied the elements of the 10b-5 claim.<sup>134</sup> Reasoning that because class-wide evidence of reliance and damages was not provided to its satisfaction, the court concluded that the purported class not only failed the predominance and superiority analysis under Rule 23(b)(3),<sup>135</sup> it also failed to meet many of the prerequisites under Rule 23(a).<sup>136</sup>

On appeal, the Third Circuit generally approved of the district court's analysis. Although it disagreed with much of the court's Rule 23(a) reasoning,<sup>137</sup> the panel agreed that the proposed class failed to satisfy both the predominance and the superiority requirements under Rule 23(b)(3).<sup>138</sup>

In terms of predominance, the court's analysis turned on the determination that “automated execution of orders at the NBBO listed price did not necessarily injure each class member.”<sup>139</sup> The court reached this conclusion because, first, there was no class-wide proof that the alternative sources of liquidity provided a superior price to each class member.<sup>140</sup> Second, because the other factors that bear upon whether a

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129. *Merrill Lynch II*, 191 F.R.D. at 395.

130. 647 F.2d 388, 394-95 (3d Cir. 1981).

131. *Merrill Lynch II*, 191 F.R.D. at 395.

132. 67 F.R.D. 457 (N.D. Ill. 1975).

133. *Merrill Lynch II*, 191 F.R.D. at 395 (quoting *Ampress Brick Co.*, 67 F.R.D. at 460) (internal quotations omitted).

134. *Id.* at 396.

135. *Id.* at 398.

136. *Id.* at 397.

137. The Third Circuit rejected the district court's Rule 23(a) analysis, holding that the Rule 23(a) prerequisites set a lower threshold than the predominance and superiority requirements of Rule 23(b)(3). *Newton II*, 259 F.3d at 181. It held that the proposed class met the lower standards in Rule 23(a), but not the heightened Rule 23(b)(3) standards. *Id.* at 187-93.

138. *Id.* at 193. For a general discussion of the court's certification analysis, see *In re Linerboard Antitrust Litig.*, 203 F.R.D. 197, 219 (E.D. Pa. 2001); *Andrews Sec. Litig. & Reg. Rep.*, *supra* note 17.

139. *Id.* at 187.

140. *Id.*

service provides the best execution vary from class member to class member and from trade to trade, the duty of best execution is a highly individualized standard.<sup>141</sup> Therefore, the court held that determining whether or not there was a breach of the duty of best execution that damaged each individual class member would be a “Herculean task, involving hundreds of millions of transactions” that “counsels against finding predominance.”<sup>142</sup>

The court additionally rejected plaintiffs’ proposed formula for calculating damages.<sup>143</sup> The court viewed the plaintiffs’ formula as a means of skirting the predominance requirement.<sup>144</sup> Regardless of whether Dr. Mendelson, the plaintiffs’ expert witness, could create a workable formula, the court was persuaded that the defendants’ right to assert unique defenses for each class member threatened to turn the class action into a series of mini-trials over each member’s proof of economic loss.<sup>145</sup> Emphasizing that “[p]roof of injury (whether or not an injury occurred at all) must be distinguished from calculation of damages (which determines the actual value of the injury),” the court decided that providing a formula to calculate damages does not suffice for class-wide proof of damages.<sup>146</sup> Rather, the class must establish class-wide damages via class-wide proof.<sup>147</sup> The court distinguished the “fraud-on-the-market” theory<sup>148</sup> in which defendants’ actions alone produce a harm to the investors, regardless of the investors’ actions, and demanded proof of individualized damages in order to meet the requirements of Rule 10b-5.<sup>149</sup> It analogized the case to a mass tort, in which each individual’s pre-tort and post-tort conditions were unique and had a significant bearing upon the existence of

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141. *Id.* For a discussion of the other factors *see supra* note 101 and accompanying text.

142. *Newton II*, 259 F.3d at 187.

143. Plaintiffs’ expert witness, Dr. Hiam Mendelson, a NASD market expert, claimed that he could “devise a formula which measures classwide damages and from which a plan of allocation can be constructed.” Brief for Appellants at 41, *Newton v. Merrill Lynch*, 259 F.3d 154 (3d Cir. 2001) (No. 00-1586) (citing JA1450-51, Mendelson Cert. Decl. at ¶ 10). While the details are not provided, the formula would be established “using ‘well-established statistical techniques’ based on his ‘familiarity with statistical relationships which can be powerfully applied to the relevant market data.’” *Id.* Presumably, the formula would not provide a uniform amount to each member of the class, but would rather provide differing amounts based on a variety of factors.

144. 259 F.3d at 187.

145. *Id.*

146. *Id.* at 188.

147. *Id.* at 190. The court explained that the plaintiffs must establish proof of damages for all class members via class-wide evidence or else justify a presumption of economic loss. *Id.* The court was not persuaded that plaintiffs had accomplished either in *Newton*. *Id.*

148. *See supra* note 85.

149. *Newton II*, 259 F.3d at 188-89.

an injury, as well as the degree of injury.<sup>150</sup> Finally, as noted above, even if the class could have provided class-wide evidence of injury, the court held that the defendants could still have produced individualized defenses against each class member.<sup>151</sup> Thus, the Third Circuit concluded that the plaintiffs failed to meet the predominance requirement of Rule 23(b)(3).<sup>152</sup>

The court also rejected the plaintiffs' analogy to a deceptive sales case, *In re Prudential Ins. Co. of Am. Sales Practice Litig.*<sup>153</sup> Reasoning that *Prudential* was certified for the sole purpose of settlement, the court was not persuaded by the analogy.<sup>154</sup> The court then proclaimed that Rule 10b-5 claims satisfy superiority only if the litigation results in fewer individualized actions.<sup>155</sup> Having already determined that each class member would have to prove damages individually,<sup>156</sup> the court concluded that certifying the class would not "reduce litigation" or promote judicial efficiency.<sup>157</sup>

The court also found that the proposed class failed to meet the superiority requirement of Rule 23(b)(3).<sup>158</sup> The court articulated the standard that "class action must represent the best 'available method for the fair and efficient adjudication of the controversy.'"<sup>159</sup> This provided justification for the court to examine the potential difficulties with respect to the class.<sup>160</sup> The court was persuaded that the threat of individualized questions about damages posed a risk of turning the case into a "mind-boggling undertaking."<sup>161</sup> The plaintiffs contended that, because the amounts of injury were so small, a class action represented the only way to obtain relief. The court rejected this position.<sup>162</sup> Additionally, the court cited general manageability problems with regard to a class the size of plaintiffs' proposed class.<sup>163</sup> The court believed that the "specter of

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150. *Id.* at 190-91 (citing *Amchem Products, Inc. v. Windsor*, 521 U.S. 591 (1997)).

151. *Id.*

152. *Id.*

153. 148 F.3d 283 (3d Cir. 1998). In *Prudential*, the Third Circuit approved the certification of a class solely for the purposes of settlement. *Id.* at 290. The class alleged a uniform deceptive sales practice that defrauded eight million clients by failing to disclose certain practices. *Id.* at 289. The class claimed no personal injuries and there were no future classes. *Id.*

154. *Newton II*, 259 F.3d at 192.

155. *Id.* (citing *Amchem*, 521 U.S. at 620).

156. *Id.* at 190.

157. *Id.* at 192.

158. *Id.* at 191-93.

159. *Id.* at 191 (citing Rule 23(b)(3)).

160. *Id.*

161. *Id.* (quoting *Merrill Lynch II*, 191 F.R.D. at 398).

162. *Id.* The court noted that large financial institutions might have a large enough interest to move forward with the litigation independent of a class. *Id.*

163. *Id.* at 191-92 (citing *Amchem*, 521 U.S. 591, and *In re Prudential Ins. Co. of Am. Sales*

adjudicating plaintiffs' claims at trial [was], at the very least, daunting."<sup>164</sup> These "insurmountable manageability problems" and the "hydraulic pressure on defendants to settle" provided further rationale for the holding.<sup>165</sup> Because of the threat of individual defenses and general manageability concerns, the court concluded that the proposed class failed to satisfy the superiority requirement of Rule 23(b)(3).<sup>166</sup>

With the court's analysis in mind, this discussion now provides, first, a critique of the court's analysis and, second, a potentially better avenue to serve the '34 Act and Rule 10b-5.

#### IV. ANALYSIS

Even though the Third Circuit's analysis in *Newton* is reasonable, it produces a result that runs counter to the regime's goals and the trend in Rule 10b-5 cases.<sup>167</sup> The decision is misguided for two reasons. First, although at first blush the logic appears sound, a further look reveals flaws. Second, the decision departs from the goals of the '34 Act as well as recent Rule 10b-5 decisions.<sup>168</sup>

As noted above, the court declined to certify the class on the basis that the proposed class failed to satisfy the "predominance" and the "superiority" requirements for a class action.<sup>169</sup> However, the court's analysis is flawed with regard to both requirements.

The court's discussion of the predominance requirement puts the cart before the horse.<sup>170</sup> The court found that the "Herculean task" of calculating individual damages overwhelmed the common questions.<sup>171</sup> Yet, the common issue for the class was whether a broker-dealer fulfilled

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Practices Litig., 962 F. Supp. 450 (D.N.J. 1997)).

164. *Id.* at 192.

165. *Id.*

166. *Id.*

167. *See supra* notes 70-85 and accompanying text.

168. In addition, the court also declined the opportunity to add needed clarity to the duty of best execution. *See supra* notes 86-105 and accompanying text. While the "reasonable efforts" standard provides some guidance, certifying this class forces the court to confront the issue with respect to non-NBBO sources of liquidity. Despite the fact that one may prefer that the S.E.C., not the judiciary, define the duty of best execution, the SEC's decision to simply incorporate the services in question into the NBBO only delays further definition, but it does not avoid it. Moreover, such a decision could have effects on the controversial issue of payment for order flow. *See Ferrell, supra* note 18. In the end, although the decision certainly does not foreclose future cases that can provide further definition to the duty of best execution, this case presented just such an opportunity and it should have been embraced.

169. *See supra* notes 120-66 and accompanying text.

170. *Newton II*, 259 F.3d at 187.

171. *Id.*

the duty of best execution when that execution systematically ignored potentially superior prices.<sup>172</sup> The broker-dealer should be judged with regard to her *process* of execution rather than the *outcome* of it, i.e., did the broker-dealer use “reasonable efforts” to obtain the best execution?<sup>173</sup> This question, common to all members of the class, is *the crucial issue* in the litigation because it is an initial hurdle that each plaintiff must surpass.<sup>174</sup> It is in this sense that common questions predominate.

Furthermore, the court’s analysis acknowledged that the duty of best execution is client-specific and that the duty is defined by multiple factors that are unique to each client.<sup>175</sup> It is hard to square this with the decision to insulate the defendants’ policies that systematically treat each client as if they were identical.<sup>176</sup> Indeed, if the duty of best execution is client-specific, why do the firms maintain *uniform* policies to fulfill the duty? And why should the court rigidly apply a certification standard that it understands as requiring individualized proof of damages when it is clear that the defendants uniformly failed to meet their obligations? The Third Circuit did not adequately answer these questions. Instead, the court ignored its own admonition to distinguish proof of injury from calculation of damages.<sup>177</sup> Because the plaintiffs claimed a breach of the duty of best execution with respect to each client,<sup>178</sup> the evidence of injury should have come from common proof that the defendants uniformly failed to fulfill the duty of best execution based on the system they used. In other words, the plaintiffs contended that the harm arose from the *process* by which each client’s trade was executed, not its *outcome*.<sup>179</sup> To demand more from the plaintiffs would be to demand common calculation of damages, which the court cautioned to avoid.<sup>180</sup> Therefore, the requisite evidence should demonstrate that the system did not adapt to individual differences or consider the potential for better prices.<sup>181</sup> If anything, it is the proof of

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172. *Id.* at 173.

173. *See supra* notes 87-105 and accompanying text.

174. If the court holds that there is no breach of the duty of best execution on this theory, then the class as a whole fails to allege a material misrepresentation and therefore has no basis for a Rule 10b-5 claim. If the court holds that the duty of best execution is fulfilled based on outcomes rather than process—price rather than “reasonable efforts”—then certification cannot be given and each individual outcome must be analyzed.

175. *Newton I*, 135 F.3d at 270.

176. *Id.* at 269.

177. *Newton II*, 259 F.3d at 187-88.

178. *Newton I*, 135 F.3d at 270.

179. *Id.*

180. *Newton II*, 259 F.3d at 187-88.

181. Evidence is presented via proof of the firms’ uniform policies. *Id.* Such evidence would establish that, for each member of the class, under the defendants system the broker-dealers did not,



injury which is common and the calculation of damages which is individualized, assuming rejection of the plaintiffs' formula for calculating damages.<sup>182</sup> Thus, with respect to proof of injuries, common questions predominate.

The court's superiority analysis is also flawed.<sup>183</sup> The court first asserted that certifying the class would lead to a larger burden on the judicial system than not certifying because a more complicated examination of damages would be required.<sup>184</sup> Secondly, the court concluded that to certify the class would put undue "hydraulic pressure" on the defendants to settle.<sup>185</sup> The former argument sacrifices justice in order to ease the burden on the court system and the latter misplaces the burden on the plaintiffs as a matter of policy.<sup>186</sup>

The court reasoned that, even if plaintiffs can prove the injury with class-wide evidence, the defendants retain the right to claim individualized defenses.<sup>187</sup> In this situation, however, because of the *individualized* nature of the duty of best execution standard and the *uniform* policies that the defendants applied to achieve that standard (always using the NBBO), their defense would stand or fall for the class as a whole. Because the duty of best execution is about the *process* of execution, not the *outcome*,<sup>188</sup> the defendants' individualized defenses would never be successful. In other words, the potential for individualized defenses does not alter the common question: whether the duty of best execution is fulfilled via uniform execution policies. This question still predominates for the class.

In terms of the increased litigation stemming from certification, the court must assume that the refusal to certify the proposed class sounds the death knell for at least some of the class members. If any of these claims are legitimate, the ruling sacrifices justice to some degree. Even if the court is correct in asserting that determining damages would require it to look to each individual member in isolation, it would be no more burdensome on the court than if each individual pressed their claims

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could not, and never intended to use "reasonable efforts" to seek out the best prices for their clients. Accordingly, the failure to disclose constitutes a material misrepresentation or omission under Rule 10b-5.

182. This is because the calculation is subject to each security's price on the NBBO and its alternatives.

183. See supra notes 158-66 and accompanying text.

184. *Newton II*, 259 F.3d at 191-92.

185. *Newton II*, 259 F.3d at 192.

186. As discussed below, the first argument inevitably leaves those who have legitimate claims without a viable means of obtaining relief. The second is simply an unwise policy.

187. *Newton II*, 259 F.3d at 192.

188. See supra notes 87-105 and accompanying text.

separately. Indeed, combining them would be more efficient for two reasons. First, a class would unify the counsel and strategies. Second, it would avoid repetitive liability litigation that may be followed by the damage assessment. Thus, in order for there to truly be an efficiency benefit to the court in requiring each member to press their own claims, the court must assume that there are many individuals who would not continue their cases.<sup>189</sup> In other words, the argument presumes that the denial of certification prevents the filing of at least some, if not all, claims. Presumably some of those claims would be legitimate.<sup>190</sup> Therefore the court sacrifices justice for efficiency.

Furthermore, as a matter of policy, the court arguably misplaces the burden in order to avoid the “hydraulic pressure” on the defendants to settle the case that arises from certification.<sup>191</sup> Although this argument is logical, given the protective purpose of the ’34 Act,<sup>192</sup> the statute arguably demands the burden of this pressure be placed on the broker-dealers, not the investors. The firms are better able to bear this burden than the individual investors.<sup>193</sup> Most importantly, even though the thousands of investors lost relatively small amounts of money,<sup>194</sup> that money was concentrated in one beneficiary.<sup>195</sup> Placing the burden on the clients insulates the broker-dealers so long as they defraud the clients of only small amounts of money.<sup>196</sup> This creates a collective action problem in that the suit is likely not worth the expense if the individual is required to bear it alone,<sup>197</sup> but might be worth the expense as either a member of a group

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189. In order to have an efficiency gain, the court must assume that there is a large number of plaintiffs who will no longer assert a claim. If it is correct that the litigation will devolve into a series of individual trials over damages, then the trial would be a combination of the single litigation over the common liability issues and then individualized damage issues. The denial of certification would require everyone who brings a claim to fully litigate each issue. Thus, in order for there to be an efficiency gain, the court must assume that the number of people who bring their claim, regardless of certification, is so greatly outweighed by the number of individuals who, without certification, will not assert their claim at all that, when aggregated, their full trials still do not consume more judicial resources than the single class action.

190. Given the unique nature of the duty of best execution, this presumption is virtually undeniable.

191. *Newton II*, 259 F.3d at 192.

192. *See supra* notes 70-86 and accompanying text.

193. The firms are better able to bear the burden because they are financially capable and retain in-house counsel.

194. *See supra* note 29.

195. Plaintiffs even claimed that defendants’ actions were motivated by generating extra profit. *See supra* notes 54 and 67.

196. The broker-dealer is insulated because the cost/benefit analysis for litigation only presses the claims if it is worth it.

197. *See supra* note 4.

or if the individual can benefit from the success of another plaintiff. As it stands, however, the cost-benefit analysis of individual claims discourages their filing. In terms of the policy implications, the court should certify the class and place the burden on the broker-dealers, even if it places “hydraulic pressure” on them to settle.<sup>198</sup>

Aside from the flaws in the court’s logic, the denial of certification ignores the purpose of the ’34 Act and the teachings of recent Rule 10b-5 decisions.<sup>199</sup> Given the broad goals of protecting the integrity of the market and promoting investor confidence through disclosure,<sup>200</sup> impediments to enforcement ought to be viewed with skepticism. The court’s decision in this case should be viewed similarly. First, it acknowledges that it is reducing litigation in the name of efficiency. Second, because of the collective action problems and the small individual amounts involved,<sup>201</sup> a class is critical to bringing relief to the injured plaintiffs.<sup>202</sup> Third, it decreases deterrence by reducing the threat of litigation. All of these leave class members uncompensated for their injuries and future investors uncertain. Since the Supreme Court has tended to broaden, not narrow, Rule 10b-5 litigation, it seems appropriate to do so here. Concededly, there is no “fraud on the market”-type harm here, but the market as a whole is injured by the unpunished fraud. Protecting the integrity of the market and protecting investors from fraud is the thrust of Rule 10b-5 and the court ignores this goal by denying certification.

## V. PROPOSAL

The court should have certified the class for all, or at least most, of the litigation. Initially, the *predominant* question in this case regards the fulfillment of the duty of best execution via the defendants’ uniform policies. This duty is one of “reasonable efforts” and is thus one of process, not outcome. It is not the calculation of damages that is crucial, but the proof of injury—proof that will be given with class-wide evidence that the defendants systematically failed to fulfill their duty of best execution—that determines predominance (applying a uniform policy to satisfy a variable duty). If this is not satisfactory, the court could have

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198. This is not to assume that defendants are liable, but only that they are better able to bear the costs and, if they are indeed liable, then the judicial system is much more likely to deliver justice.

199. See *supra* notes 71-86 and accompanying text.

200. *Newton II*, 259 F.3d at 192.

201. See *supra* note 29.

202. See *supra* note 4.

simply certified the class for the sole purpose of litigating liability.<sup>203</sup> Limited certification strikes a better balance between the desire to keep the justice system available to those with grievances and the efficiency demands of the court than does outright rejection of certification.

Certification of the class better serves the protective purposes of the '34 Act. Rather than insulate the broker-dealers from the harm caused to their clients from their potentially fraudulent conduct, the '34 Act requires that the plaintiffs be given a chance to protect their interests. Because of the lack of enforcement without class action, certification is critical to protecting market integrity and investor confidence. Limited certification does not allow frivolous claims, because an allegation of fraud must be proven, but the denial of certification removes a needed method of protection.

## VI. CONCLUSION

The Third Circuit's decision to uphold the denial of certification in *Newton* is problematic in that it removes one important avenue that injured investors had to seek relief. In doing so, it also decreases the deterrent effect of liability for violations of Rule 10b-5. But the court's hands were not tied. Rather than conflate proof of damages and calculation of damages, it could have reasoned that a uniform policy aimed to fulfill a varying standard fails to such an extent that it warrants finding predominance and superiority under Rule 23(b)(3). Although this proposal suggests a relaxed standard for damages in this case, it nevertheless better serves the goals of Rule 10b-5. The choice appears to be between strictly adhering to certification rules and better serving the '34 Act. Even though the Third Circuit makes a strong argument for its decision, the choice removes one critical check investors have over their agents.

*Brian J. Wanamaker\**

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203. The partial certification is not new. *See* WRIGHT AND MILLER, FEDERAL PRACTICE AND PROCEDURE, 7B Fed. Prac. & Proc. Civ.2d § 1805 (2001).

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