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TOP DOWN INSIGHTS…BOTTOM LINE RESULTS

One Rational Judge

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Sometimes, that's all it takes to reverse a nasty trend – and to set the stage for a sustained investment recovery. Just one, rational judge. A judge who's able (and willing) to reject the false theories of desiccated academics, to dismiss the yellow journalism of *The New York Times*, to treat with skepticism the claims of grasping regulators, or to lend a deaf ear to the screams of populist mobs. A truly rational judge: one who knows the law (instead of making it up), exerts his independence (instead of selling it to the lowest bidder) and thinks for himself (not with his mom's "intuition"). A judge who rules *justly – popular opinion be damned*.

Thankfully, there *is* such a judge: 96-year-old Milton Pollack, in the Federal District Court in Manhattan. Third-oldest federal judge in America, Pollack is a specialist in securities law and shareholders suits; he has presided over such cases for nearly a *half-century*. He has seen it all: the legitimate and illegitimate, the frivolous lawsuits and genuine ones. But it's clear – from his most recent decisions – that Pollack doesn't blithely assume that whining plaintiffs are always right, just because they've made some bad investments. Nor does he seem to treat large corporations, the so-called "big pockets," as welfare agencies obligated to provide handouts to the undeserving. He is dedicated to *dispensing justice* – not sympathy or facial tissues.

Imagine what Pollack must have faced recently – the *wider context* in which he took on the case of *Aggrieved Investors v. Merrill Lynch & Co.*[1] He faced a battery of unwavering public opinion that had become *convinced* (with the help of *The New York Times*) that stock prices crashed in 2000-2002 merely because Wall Street firms had recommended buying the stocks. Probably he'd heard about so-called "tainted research" and of securities regulators (together with New York Attorney General Elliot Spitzer) getting a $1.4 billion, out-of-court (i.e., backroom) "settlement" from ten Wall Street brokerage firms, even though none of them admitted having defrauded anyone. Pollack also must have read some of the shoddy journalism claiming brokers are frauds *at root* – and that their selfish interest lies in ensuring that clients lose tons of money.

Smashing Spitzer's "template." It's likely that Pollack also had heard Spitzer's brazen claim, made back in April 2002, in the wake of him forcing Merrill Lynch to pay his department a $100 million fine, that he would use it as a "template" for extract-

[1] We joke about the name of the plaintiff – but not about that of the defendant. We don't know the specific names of the plaintiffs, but we can just imagine their feelings of being "aggrieved." In their suit they admitted to buying shares in companies like Interliant, Inc. and 24/7 Real Media, Inc. – internet stocks that plunged more than 99%, from peak to trough. They claimed that Merrill made them do it.

[2] For our discussion at the time, see "War, Gold, Research and Jobs," *Investor Alert*, InterMarket Forecasting, Inc., December 20, 2002, pp. 4-5.

[3] As much as $500 million of it is to be set aside in a fund from which brokers must *subsidize competitors* – so-called "independent" research. In our view, once any such firm *takes a penny* of this loot, it can no longer be described as "independent."

ing *many millions more* from *other* brokers. In fact, as we know, Spitzer *did* extract more – up to $1.4 billion – last December.[2] Merrill paid yet *another* $100 million. Yet *not a cent* of that booty was ear-marked for any allegedly-harmed investors; most of it, in fact, was to be wired to the bank accounts of Spitzer's department.[3] In issuing his legal opinion earlier this week, while ruling in *favor* of Merrill Lynch, Pollack effectively *smashed* the much-heralded Spitzer "template" – and *threw it out of the courtroom window*. Here's an excerpt from Pollack's opinion, on plaintiffs' bogus claims:

> High-risk speculators who, realizing the unjustifiable risks they were undertaking in the extremely volatile and untested stocks at issue, now hope to twist the federal securities laws into a scheme of cost-free speculators' insurance.[4]

Pollack went on to say he was "utterly unconvinced" that Merrill Lynch had defrauded – or had even *intended* to defraud – the Internet-stock-speculators-defendants who were standing before him. Pollack got it *absolutely right*. Although (unfortunately) his decision won't be enough to *reverse* the $1.4 billion extortion committed by Spitzer, it *should* go along way toward *stifling* the chance that thousands of *private* lawsuits – piggy-backing on Spitzer's crime and totaling, potentially, *multi-billions of dollars* – will ever succeed. All else equal, that's *bullish* for the U.S. stock market – and certainly bullish for stocks of the brokerage firms.[5]

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In a bit of classic irony – or what sometimes is described as "sweet justice" – Pollack also had the good sense to use Spitzer's Gestapo-style approach *against* him. In 2002 Spitzer had dragged out of the regulatory arsenal, to deploy as his main weapon of injustice, an obscure New York law known as the Martin Act. Here's how *The Wall Street Journal* described the Act – and Spitzer's use of it – more than a year ago:

> Mr. Spitzer has a *big weapon* in his *arsenal*: A New York State law known as the Martin Act *gives the attorney general wide authority* in bringing civil and *even criminal charges* against firms. And unlike the federal securities laws, *the state law doesn't require Mr. Spitzer to show "criminal intent"* when bringing *either kind of charge*, his office says. He *merely* has to show, for instance, that a firm *failed to disclose* a conflict of interest, such as investment-banking relationships, when issuing *research that ultimately hurt investors*.[6] (emphasis added)

At the time we excoriated Spitzer for using this "weapon" – and we named the obvious injustice of a tactic whereby "New York can launch *criminal* charges – *without a showing of criminal intent*."[7] How did *Pollack* interpret Spitzer's use of the Martin Act, as it pertained to the case before him? He observed how Spitzer seemed *unable to find fraud*, since he had resorted, desperately, to the use of a statute that *doesn't require a showing of fraud* (or even of fraudulent *intent*). This week Pollack noted, correctly, that the tactic *alone* suggested *a lack of fraud* – in a case before him that was *predicated* on a *claim of fraud*. Take that, Mr. Spitzer.

Show me the facts. Pollack's decision was commendable for other reasons. He argued that investors-plaintiffs had failed to demonstrate "loss causation" and had failed to show that Merrill Lynch had engaged in any "precise misrepresentations and omissions." He further pointed out that both Merrill's research and the general media's accounts of the "Internet boom" were *replete* with discussions of the high risks involved and of the high-valuations that *already* had been exhibited by the stocks at issue, at the time of their purchase.

[4] Cited in Randall Smith, "Judge Jeers at Stock-Hype Cases," *The Wall Street Journal*, July 2, 2003, p. C1.
[5] Just as the stocks of the publicly-traded brokerage firms *collapsed* last summer amid Spitzer's raids – and collapsed by *more* than either the S&P 500 or the *Financials* sub-sector did – they have *outperformed dramatically* in the *past* week, in the wake of Pollack's decision (released on June 30th).
[6] "Merrill Lynch to Pay Big Fine, Increase Oversight of Analysts," *The Wall Street Journal*, May 22, 2002, p. A12.
[7] "A 'Template' for Persecuting Wall Street," *Investor Alert*, InterMarket Forecasting, Inc., September 30, 2002, p. 3.

Why do we say this is commendable? Many judges today, upon seeing a plaintiff and his loss, blithely disregard the crucial, *evidentiary* issue of *cause-and-effect* – and simply rule with their "hearts," in favor of the teary ones. Rational Pollack, in contrast, requires a showing of a *casual connection* between Merrill's acts and plaintiffs' loss. Simple justice. He also requires *precise* findings of wrong-doing, not ambiguous assertions. *Facts* – not feelings. As for the wider context, Pollack reasonably assumes plaintiffs are *breathing*, *sentient beings*, aware of what's going on in the world around them – able to read newspapers and at least glimpse whether the stocks they propose to buy are *safe* or *speculative* – and to know the *difference*. Plain justice.

In a similar vein, last September we wrote:

> How can *research* reports "hurt" investors? Do investors *read them in blind gullibility* and *act on them to their own detriment*? What about *free will* or *caveat emptor* ("let the buyer beware")? Any "investor" who believes he can be hurt (or brainwashed?) by some research reports from Wall Street *is an idiot who ought not to be anywhere near CNBC*, let alone near a *financial publication* or *brokerage office*. If he *does* happen to stumble onto such a mindless network, or toward such a publication or into such an office – and if he then *hurts himself* (or his *portfolio*) – *he has no one but himself to blame for the consequences*.
>
> . . . What about the *fact* that *every* research report issued by Wall Street has a *disclosure section* that *informs the reader* if an investment banking relationship exists? What about the *fact* that it is *common knowledge* that research reports are written precisely *because* a brokerage firm has agreed to become a firm's *underwriter*?...What about the *fact* that an "investor" who does *not* know these things either *does not read the reports* and/or *does not live on this planet*? Facts be *damned*, says Spitzer . . . [He] will prosecute innocent brokerage professionals – and have them artificially re-arrange and separate their business divisions – because of the *self-admitted idiocy* of "small investors" who apparently *do not read research reports*.[8]

We now can amend our use of the word "apparently" in that last sentence. For we've learned recently, from none other than *The New York Times*, that in the case before Pollack "the plaintiffs were not Merrill Lynch clients and never claimed to have actually read and relied on [Merrill's] research in making their decisions."[9] Not only does this *confirm* our original assessment, but it also shows that plaintiffs had *no judicial standing*. Had Pollack been *completely* objective and abided by *strict legal principles* he would have thrown the case out *without even hearing it*. But in today's context, we're *glad* he issued his scathing decision.

It's interesting that Pollack noticed how plaintiffs hoped, in his words, "to twist the federal securities laws into a scheme of cost-free speculators' insurance." That's a decent characterization of what they *did* hope to accomplish. But it should be understood – even if Pollack may not understand it (he doesn't oppose the securities laws *per se*, or the SEC's existence) – that no great "twists" are required. Contrary to popular opinion (in *and* out of the legal profession), the securities laws are *not intended* to "protect" – and in practice certainly *do not protect* – investors. Their aim is to shackle securities issuers and brokers. As for the SEC, its main *influence* – if not, indeed, its main *goal* – has been to *promote reckless investing*. As we've written:

> At most [the "aggrieved" investor] might want to blame (*legitimately*) the *securities regulators*, who continue to push the *propaganda* – propaganda that's *far worse than anything a Wall Street stock-jockey or huckster could dream up* – that *any idiot should feel free (and confident) to take a plunge in the stock market* and be assured of a *sure gain*, because the "public-spirited" regulators will "guarantee" the "integrity" and "safety" of the market."[10]

Once upon a time. Pollack's decision bespeaks a *far-different age* – a far-*earlier* era, many *decades* ago, when people *actually took responsibility for their own actions* (and character). It was a time when they were *embarrassed to take a welfare check*, let alone take their broker to court for their own bad judgment. It was

[8] *Ibid.*, p. 3.
[9] "Judges Reject Suits Blaming Analysts for Losses," *The New York Times*, July 2, 2003, p. 8. The title of the article refers to "judges' in the plural because, in addition to Judge Pollack's ruling, last week Judge Harold Baer (also in the Federal District Court of Manhattan) dismissed some shareholder lawsuits against New York brokers, on *technical* (*less-philosophical*) grounds.
[10] See "Template" (footnote 7), p. 3.

a period when people believed men have *free will* (as they do), that they aren't puppets manipulated by mysterious forces beyond their control, that they're never to be seen (wouldn't *dare* to be seen!) as *perpetual victims* of some conspiratorial cosmos – or of some trumped-up perpetrators, like Big Business or Big Brokers. In that era men held that *voluntary interaction* – whether its results turned out well or ill – wasn't "illegal" if it occurred between *consenting adults*.

When *was* that age? *About a hundred years ago*. Pollack, born in 1907, *grew up in that age*. Son of Russian immigrants, he received his B.A. in 1927 and earned his law degree in 1929. We don't know Pollack's full biography or the precise course of his intellectual development. But we *do* know he was educated – and matured as a man – *in that age*. That was *before* the rise of the welfare state – *before* the creation of the SEC and the regulatory state – *before* the Congressional witch-hunts and scape-goating that began to occur later, as a matter of routine, after every market plunge. It was also before the litigation-obsessed "modern" era – and *well* before the time when the *losers* of the world would be taught to *shamelessly blame others* (especially the *winners*) for their troubles (or their portfolio losses). Pollack, of course, has lived through these detrimental changes; but through it all he seems to have retained the *more rational* influences of his *youth*.

Any legal decision that rejects the claims of irrational investors redounds, however indirectly, to the benefit of rational investors.

Some readers may wonder why we characterize Pollack's decision as *bullish* for the market, for investment and for investors – especially when the ruling actually came out *against* specific investors (the plaintiffs). The decision favors the market because Judge Pollack's ruling went against *irrational* investors – those who clearly can be described as irrational for investing blindly in untested, shoddy stocks – the so-called "investors" who *compounded* their *original* irrationality by running to court and demanding a legally-mandated *subsidy* for their freely-chosen mistakes. Any legal decision that rejects the claims of irrational investors redounds, however indirectly, to the benefit of *rational investors* – those who are the *prime movers* of markets.

Just as Judge Pollack was wise to use Elliott Spitzer's resort to Gestapo-style tactics *against* him (and the plaintiffs), he *could have* used the ridiculous claims of Alan Greenspan as well. Recall that Greenspan – whom everyone conveniently cites (as some cite the Bible) whenever they wish to "prove" any arbitrary claim whatsoever – attributed the market rise of the late 1990s to the alledged "irrational exuberance" of investors. That was pure *poppy-cock*.[11] But it was *Greenspan-esque* poppy-cock, so everyone took it as *gospel*.

Judge Pollack easily could have described the plaintiffs before him as the epitome of the "irrationally-exuberant" investors about which God Greenspan spoke so derisively. They certainly could not be said to represent *all* – or even a tiny *fraction* – of the total investors in the world. But as the *irrational* ones, they certainly had no case in court. Pollack could have added that *no man* can make a case for restitution when *he*, not the defendant, has acted irrationally and stupidly. Just as *ignorance of the law* is not a legitimate *defense*, so *ignorance of reality* is not a legitimate *plaint* – unless, of course, it's a plaint *against* one's self and character.

Some *legitimate* lawsuits. Given Pollack's decision, it's too bad executives of Wall Street broker-

[11] See "The Rational Basis of Price-Earnings Multiples," *The Capitalist Advisor*, InterMarket Forecasting, Inc., June 15, 2000. We did *not* argue that stock prices *could* not crash (they obviously had in the *past*) – but that if they *did* crash it would be due, not to the *prior rise* but to *irrational* (and *wealth-destroying*) *government policies*. Those are *precisely* the kind of policies that *were* inflicted on the U.S. market in 2000-2002. See also Richard M. Salsman, "Rational Pessimism," *The National Post (Canada)*, June 11, 2002.
[12] "Bond Market Association Praises Overturning of Bear Stearns Verdict," *Dow Jones Newswires*, September 20, 2002.
[13] See "Template," (footnote 7), p. 6.

ages caved-in so cravenly to Spitzer last year – and it was *especially* too bad for the *brokerage shareholders* who were separated from $1.4 billion of *their* wealth. For all the dictatorial powers wielded today by government, the executives' capitulation certainly wasn't *necessary* (or *moral*, either, given that they *knew* their firms were *not guilty as charged*). In recent years Bear Stearns had fought similar, unjustified investor lawsuits, in *court*, and last year it *won* – when a (*rational*) judicial ruling "reaffirmed the long-standing principle that brokers do not act as guarantors for their clients' investment decisions."[12] In the context of that judicial victory, last September we wrote:

> If [brokerage firms] are *innocent* (as they *are*), why don't their lawyers take their chances in *court*, where at least *evidence* and *the rule of law* have a chance to operate? Why are these *payments to persecutors* not described as *bribes* – or, more accurately, since the *regulators* have the *real* power – as *extortion* money? Why are the lawyers so eager to dispense shareholder wealth, *not* to allegedly aggrieved customers but to *regulators*?[13]

Had these executives (and brokerage lawyers) even *tried* to "take their chances in court," they may well have found themselves, by now, *in a court with Judge Pollack*. As a result, their shareholders would have *saved* $1.4 billion and would have avoided the risk of losing billions more, in subsequent, "piggy-back" suits. The only *legitimate* suits we can imagine, in the current context, would be those launched by *stockholders of the brokerage firms* (including of Merrill Lynch) *against the firms' CEOs*, who, despite denying guilt, nevertheless *agreed to hand over $1.4 billion* (or more) of shareholder wealth to *publicity-crazed extortionists* like Elliott Spitzer.

There are *many* aspects of government policy and rule that can harm investment portfolios: such as monetary policy, tax policy and trade policy. But *regulatory* policy – and others (pertaining to property rights and contracts) that *undermine the rule of law* – can play an important (and destructive) role as well. In the case of the Pollack ruling, the influence can be *favorable*. We suspect it *will* be. Markets (and investors) will *always* benefit from the *objective rule of law* and will always be *harmed* by *Spitzerian whim* – or its equivalent.

One *irrational* judge. More than three years ago the *anti-Pollack* – namely, Judge Thomas Penfield Jackson – played a huge role in the destruction of investor wealth that began in early 2000. Jackson was the entity who decided, in April 2000, that Microsoft was guilty of violating antitrust law – and who then ruled (in June 2000) that the firm should undergo *legal vivisection*. At the time we correctly identified those decisions as *bearish* – not *only* for Microsoft's stock but for *technology stocks* and *the broader market*, as well.[14] As Spitzer did last year, then anti-trust "czar" Joel Klein described the Jackson ruling, not as a Spitzerian "template," but nevertheless *similarly* as a "landmark" decision that would be used to attack other large and successful firms in the technology industry. Every investor knows the destructive results. Klein's "landmark," in fact, became a *landmine*.[15]

Just as Judge Jackson's *unjust decisions* in 2000 preceded a *bearish* turning point in the U.S. stock market, we suspect Judge Pollack's *highly-just ruling* may turn out, in retrospect, to signal a *bullish* turning point. It helps that the *current context* has shown a *more favorable*, overall *policy mix*.[16] That certainly was *not* the case in 2000.

[14] See "Antitrust: Landmarks and Landmines," *Investor Alert*, InterMarket Forecasting, Inc., April 4, 2000. "Assault Microsoft, Assault the NASDAQ," Center for the Moral Defense of Capitalism, April 6, 2000; Richard M. Salsman, "Microsoft's Anti-Trust Lynching Undermines the Market," *Financial Post (Canada),* April 5, 2000. For an even *earlier* warning, see Richard M. Salsman, "Investment Implications of the Government's Assault on Microsoft – and on Markets," *The Capitalist Perspective*, H.C. Wainwright & Co. Economics, Inc., November 18, 1998.

[15] Not until late summer of 2001 was Microsoft (partially) vindicated, in a semi-favorable ruling by an appeals court. All else equal, that decision was bullish for the market – since it effectively over-turned Jackson's prior injustice. See "A Victory for Microsoft – and the Market," *Investor Alert*, InterMarket Forecasting, Inc., September 7, 2001. Unfortunately, any pending bullishness that might have emerged was buried, four days later, in the smoking rubble of (what was) the World Trade Center. While the appeals court had done some good, that was offset when – to put it mildly – the U.S. government failed utterly in its Constitutional obligation to provide for the national defense.

[16] See "The Policy Mix Index: Further Improvement is Visible," *The Capitalist Advisor*, InterMarket Forecasting, Inc., June 9, 2002.

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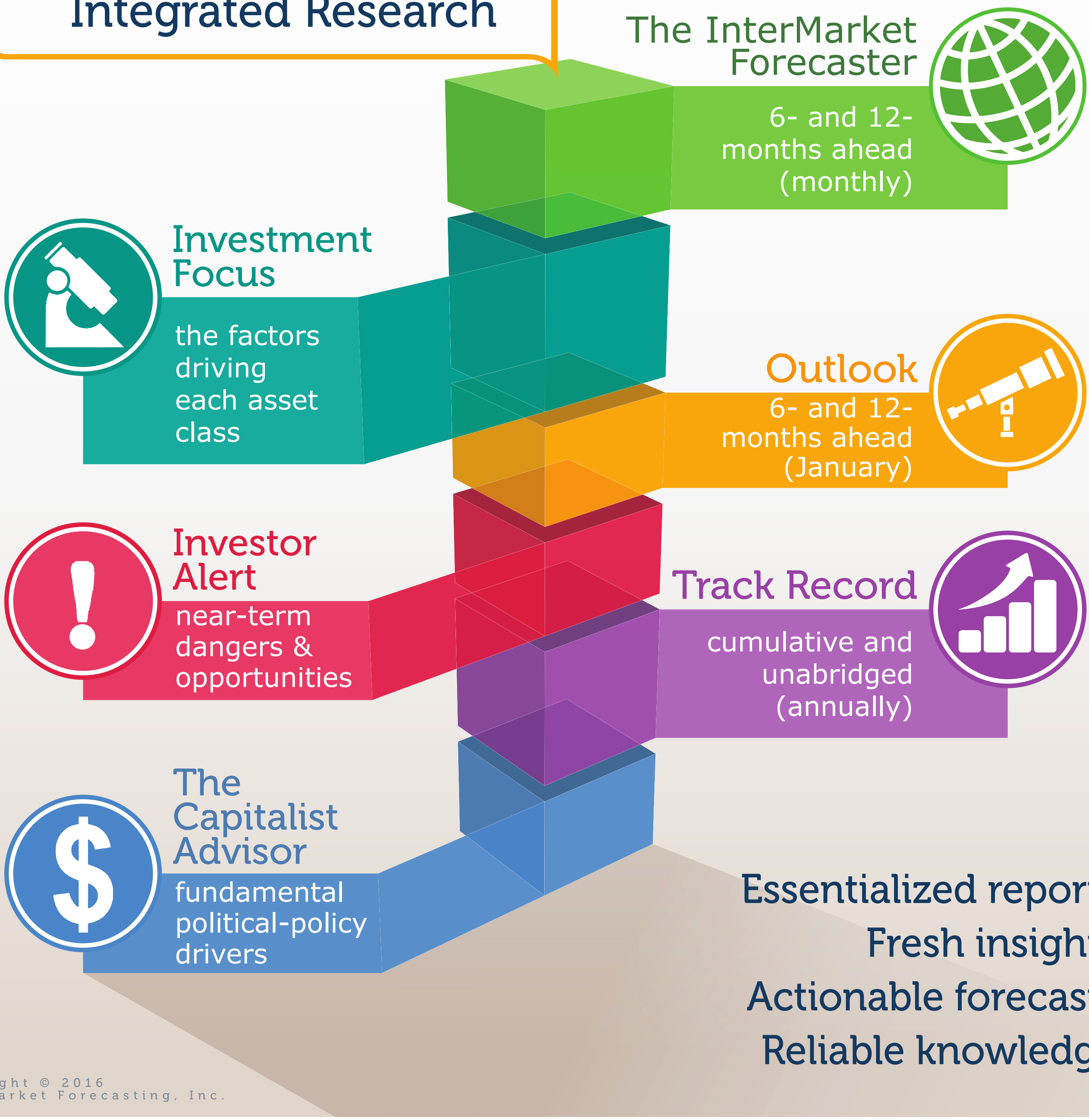

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