Should the SEC Exercise Its Authority Under Dodd-Frank to Prohibit Mandatory Arbitration Clauses?

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Section 921 of the Dodd-Frank Wall Street Reform and Consumer Protection Act allows the Securities and Exchange Commission to prohibit pre-dispute mandatory binding arbitration. Should the SEC do that? This article will briefly examine both sides of the issue and offer a proposed answer.

Background

In *Wilko v. Swan*, 346 U.S. 427 (1953), the U.S. Supreme Court held that pre-dispute arbitration agreements ("PDAAs") violated the anti-waiver provisions of the Securities Act of 1933 and were thus unenforceable. In the landmark case of *Shearson/American Express v. McMahon*, 482 U.S. 220 (1987), a 5-4 decision, the Court held that the anti-waiver provisions of the Securities Exchange Act of 1934 only prohibited waiver of the Act's substantive provisions and did not include the section of the Act conferring exclusive district court jurisdiction. Shortly thereafter, in *Rodriguez de Quijas v. Shearson/American Express*, 490 U.S. 477 (1989), 1933 Act claims were also made subject to PDAAs.

Prior to *McMahon*, the Securities and Exchange Commission promulgated Rule 15c2-2, which provided in pertinent part: "It shall be a fraudulent, manipulative or deceptive act or practice for a broker or dealer to enter into an agreement with any public customer which purports to bind the customer to the arbitration of future disputes between them arising under the federal securities laws, or to have in effect such an agreement, pursuant to which it effects transactions with or for a customer."[1] In the *McMahon* case, the SEC reversed its position and submitted an amicus brief in support of the industry's position that PDAAs should be enforced.[2] Shortly after the *McMahon* decision, the SEC recommended that investors be given contractual access to alternative arbitration forums outside of the securities industry.[3]

Mandatory FINRA-administered arbitration pursuant to universal PDAAs has thus been the *status quo* since *McMahon*, but it has also been controversial. Proponents and opponents are largely (but not monolithically) split along "party lines" with investor advocates favoring a ban on mandatory arbitration and brokerage firms opposing it.

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[1] *McMahon*, 482 U.S. at 264, n. 24 (citing C.F.R. § 240.15c2-2(a)).

[2] *H.R. 3010, The "Arbitration Fairness Act of 2007": Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 110th Cong. 117-118 (2007) (statement of Theodore G. Eppenstein).

[3] Id. at 126 (citing Letter of Richard G. Ketchum, Director, Division of Market Regulation, Securities and Exchange Comm., Sep. 10, 1987 at p. 11.) Mr. Ketchum is now FINRA's Chief Executive Officer.

Most people agree there are pros and cons to both arbitration (including FINRA-sponsored arbitration) and court litigation. In brief, the main pros of arbitration are: (1) speedier outcomes and lower costs through streamlined procedures, mainly limited discovery and motion practice; (2) greater finality through limited appellate practice (there are no appeals in the usual sense and only limited grounds to vacate an award); and (3) a pool of arbitrators that can be researched and who are generally more likely than jurors to come to trial with some understanding of the subject matter of the dispute.

The flip-side – the cons of arbitration – are the pros of court litigation: (1) court litigation offers greater procedural safeguards (broad discovery and motion practice) than arbitration; (2) in court litigation, appellate review is available to correct errors of law (many arbitrators have no legal training) and develop the law as precedent that can be relied on in future cases; and (3) court litigants, in many cases, can exercise their constitutional right to trial by jury, which is unavailable in customer disputes with FINRA members and associated persons after *McMahon*.

The Issues

Advocates of the status quo argue that so-called "mandatory" FINRA arbitration is not mandatory at all, but is voluntary, as it arises out of an agreement – the PDAA. In fact, they argue, arbitration is more voluntary than court litigation for that very reason, as court litigants can be bound by the jurisdictional power of the court whether they agree to it or not.

Critics of contractual arbitration object to PDAAs, in part, because they are typically not negotiable, but rather are presented "take-it-or-leave-it" to customers. Furthermore, PDAAs are not entered into at arms-length, since the relationship between broker and customer is confidential and fiduciary in nature.[4] As one law professor and proponent of PDAAs conceded: "That is a valid point and it is a point that applies to a wide range of contracts, not just to contracts with arbitration clauses."[5]

Proponents of contractual arbitration, however, argue that current law protects against unfair arbitration agreements. "Each year there are many cases in which courts hold particular arbitration agreements unconscionable."[6] In short, PDAA

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[4] According to the securities industry's self-regulatory organization, at least since 1940, the broker-customer relationship has always been confidential and fiduciary in nature. *See* N.A.S.D. News, published by the National Association of Securities Dealers, Inc., Vol. I, No. 2, Washington, D.C., June 22, 1940, which states in part: "Essentially, a broker or agent is a fiduciary and he thus stands in a position of trust or confidence with respect to his customer or principal."

[5] *Mandatory Binding Arbitration – Is it Fair and Voluntary?: Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. On the Judiciary*, 111th Cong. 78 (2010) (statement of Stephen J. Ware).

[6] *Id*. at 84-85 (citing, *inter alia*, STEPHEN J. WARE, PRINCIPLES OF ALTERNATIVE DISPUTE RESOLUTION 61-65 (2d ed. 2007) (collecting representative cases)).

proponents believe that issues regarding unconscionability are too fact-dependent to be handled by legislation and should be decided by courts on a case-by-case basis.

Proponents further argue that enforcement of PDAAs is good policy because arbitration benefits the customer and the public through lower costs and because arbitration is fair to customers.

Critics of PDAAs counter that FINRA-administered securities arbitration is unfair to customers. FINRA, formerly the National Association of Securities Dealers, is the securities industry's "self-regulatory organization," which, critics argue, is analogous to the fox guarding the henhouse. The low win rate for customers (it was 42% in 2006) is said to be indicative of the unfairness of arbitration. Moreover, an investor who "wins" $1.00 is counted as a "winner" even though he did not recover enough to cover his costs to arbitrate.[7]

On the other hand, PDAA proponents point out that a low customer win rate does not prove unfairness because that statistic does not shed any light on the merit, or lack of merit, of those cases, or on how well or poorly they were presented to arbitrators.

Until very recently, in claims over $100,000, FINRA rules required that one member of the three-member arbitration panel have significant ties with (such as current employment in) the securities industry. Effective January 31, 2011, however, customers in FINRA arbitration with claims over $100,000 may elect to proceed with an "all-public" arbitration panel – meaning that none of the panelists will be an "industry" arbitrator as defined in FINRA Rules.[8]

FINRA and PDAA proponents doubtless believe that the all-public panel option removes any perception or taint of unfairness from FINRA arbitration. Even under this new option, however, many customer advocates continue to be concerned that some so-called "public" arbitrators have significant connections with the securities industry, which call their fairness and impartiality into question.

There is further concern that the FINRA arbitrator pool includes those who are financially interested in being selected to arbitrate future cases. Arbitrators know that issuing even one large dollar award to a customer will almost certainly result in that arbitrator being peremptorily struck by defense attorneys in all future cases.

The securities industry is not monolithically opposed to abolishing mandatory arbitration. At least one major defense firm has acknowledged the benefits to

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[7] The FINRA filing fee alone is $1,425 for claims between $100,00.01 and $500,000, and higher for larger claims. By comparison, the filing fee for general civil litigation in Fulton County Superior Court, Atlanta, Georgia, is $213.50.

[8] FINRA Notice to Members 11-05.

brokerage firms of litigation over securities arbitration.[9] In addition, InvestmentNews, which calls itself "The Leading News Source for Financial Advisors," recently published an editorial calling on the Securities and Exchange Commission to eliminate mandatory arbitration.[10]

Brief Answer

Assuming *arguendo* the correctness of the *McMahon* Court's decision that the anti-waiver provisions of the substantive provisions of the federal securities statutes do not prohibit a waiver of the judicial forum, PDAAs are unconscionable and should not be enforced for the following reasons: (1) the broker-customer relationship is confidential and fiduciary in nature, such that PDAAs are not entered into at arms-length; (2) they are unbargained-for, "take-it-or-leave-it" contracts of adhesion; and (3) it is inherently unfair to force customers to arbitrate disputes with their brokerage firms under a system of rules created and administered by the securities industry's self-regulatory organization. Therefore, the SEC should return to the position it adopted in Rule 15c2-2 and prohibit PDAAs.

[9] Cheryl L. Haas-Goldstein and Jaliya A. Stewart, Look on the Bright Side: Analyzing the Pros and Cons of a Ban on Mandatory Arbitration Clauses in the Securities Industry, available at http://www.sutherland.com/lawyers/Detail.aspx?Attorney=1648&type=Pub&FromSearchPage=, which states, in part: "Conventional wisdom would hold that banning mandatory arbitration clauses is bad for the securities industry. But there are benefits to increasing the number of claims resolved by litigation rather than arbitration….Consequently should a potential ban on mandatory arbitration clauses be imposed, firms should recognize there may very well be a bright side to resolving some consumer claims through litigation."

[10] "SEC gave investors half a loaf in arb panel ruling," Feb. 13, 2011, *available at* http://www.investmentnews.com/article/20110213/REG/302139999 (the "half a loaf" refers to the SEC's approval of FINRA's proposed all-public panel option).