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Articles

MANDATORY SECURITIES INDUSTRY ARBITRATION: THE PROBLEMS AND THE SOLUTION

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I. THE NATURE OF THE PROBLEM FROM THE PERSPECTIVE OF THE PARTIES TO ARBITRATION

In 1987 the Supreme Court, in *Shearson/American Express, Inc. v. McMahon*,¹ held that securities fraud claims based upon section 10(b)² of the Securities Exchange Act of 1934 (1934 Act) and rule 10b-5³ promulgated thereunder are arbitrable claims.⁴ For over thirty years prior to *McMahon*, the federal courts had followed *Wilko v. Swan*,⁵ which permitted customers to disregard predispute commitments to arbitrate claims against their brokers when those claims arose out of the federal securities acts.⁶ In *Wilko* the Supreme Court found that the Securities Act of 1933 (1933 Act) provision voiding

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1. 482 U.S. 220 (1987).

2. 15 U.S.C. § 78j(b) (1982).

3. 17 C.F.R. § 240.10b-5 (1987).

4. 482 U.S. at 238.

5. 346 U.S. 427 (1953).

6. *Id.* at 438. The federal securities acts relevant to this article are the Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C.A. §§ 77a-77b (West 1981 & Supp. 1989)), and the Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C.A. §§ 78a-78l (West 1981 & Supp. 1989)).

contracts that waive the Act's protections⁷ was more important than the Federal Arbitration Act⁸ policy favoring arbitration agreements.⁹ In *McMahon* the Court re-examined the methods and procedures of securities arbitration and determined that the Securities and Exchange Commission (SEC) now sufficiently supervises the process to warrant the Court's refusal to extend the reasoning of *Wilko* to the 1934 Act.¹⁰ As a result of the *McMahon* decision, customers who had entered into predispute arbitration agreements with their brokerage firms no longer could pursue their rule 10b-5 claims against their brokers in federal court. Following *McMahon*, a number of jurisdictions held that predispute arbitration agreements are binding upon customers in regard to 1933 Act claims against their brokers,¹¹ as well as 1934 Act claims.¹² In 1989 the Supreme Court, in *Rodriguez De Quijas v. Shearson/American Express*,¹³ held that predispute agreements indeed are binding upon customers in regard to 1933 Act claims. Because state law and common law claims never were exempt from arbitration under the *Wilko* doctrine, *McMahon* and *Rodriguez* have had the net effect, for a customer entering into a predispute arbitration agreement, of making virtually all claims against the brokers arising out of disputes over the handling of the customer's account subject to arbitration.

These consequences of *McMahon* and *Rodriguez* have brought into sharp focus a host of concerns relating to the arbitration process for the legal and investment communities. These concerns include: (1) the limited ability of parties to arbitration to appeal the findings of the arbitrators, (2) the limited discovery methods available in arbitration compared to those available in litigation, (3) the absence of a reported, reasoned decision in arbitration, (4) the absence of a rule of precedent or stare decisis in arbitration, (5) the

7. 15 U.S.C. § 77n (1982).

8. Pub. L. No. 80-282, 61 Stat. 669 (codified as amended at 9 U.S.C.A. §§ 1-15 (West 1970 & Supp. 1989)).

9. 346 U.S. at 438.

10. *Id.* at 232-34.

11. *See, e.g., Rodriguez De Quijas v. Shearson/Lehman Bros., Inc.*, 845 F.2d 1296, 1299 (5th Cir.), *aff'd*, 109 S. Ct. 1917 (1988); *Reed v. Bear, Stearns & Co.*, 698 F. Supp. 835, 842-43 (D. Kan. 1988); *Ryan v. Liss, Tenner & Goldberg Securities Corp.*, 683 F. Supp. 480, 484 (D.N.J. 1988); *Kavouras v. Visual Prods. Sys., Inc.*, 680 F. Supp. 205, 207-08 (W.D. Pa. 1988); *Aronson v. Dean Witter Reynolds, Inc.*, 675 F. Supp. 1324, 1326 (S.D. Fla. 1987); *Staiman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 673 F. Supp. 1009, 1011 (C.D. Cal. 1987).

12. *See, e.g., Reed*, 698 F. Supp. at 841; *Ketchum v. Almahurst Bloodstock IV*, 685 F. Supp. 786, 790 (D. Kan. 1988); *McCowan v. Dean Witter Reynolds, Inc.*, 682 F. Supp. 741, 744 (S.D.N.Y. 1987).

13. 109 S. Ct. 1917 (1989).

lack of guidance as to the administration of multiparty controversies, (6) the degree of control effected by the securities industry self-regulatory organizations in respect to the make-up of the typical arbitration panel, (7) uncertainties regarding the standards for admissibility of evidence, (8) the relative infrequency of punitive damage awards, and (9) the collateral estoppel impact of arbitration on subsequent litigation and *vice versa*.

Many of the perceived problems with the securities arbitration system do not reflect deficiencies in the operation of the current system, but rather are a result of the very qualities that make arbitration attractive. For example, participants in arbitration have a limited right of appeal from arbitration awards precisely because they contractually agreed to forego judicial litigation and instead have their disputes considered in a more expeditious and less expensive forum.¹⁴ It is reasonable to believe that if arbitration awards were appealable for the full range of reasons for which judicial decisions may be appealed, the efficiency of the arbitration mechanism would be reduced. Disputants who find that the benefits of arbitration outweigh the sacrificed benefits of the judicial system will support arbitration. Disputants who, however, do not appreciate the benefits of arbitration will not favor the system.¹⁵ Prior to the *McMahon* and *Rodriguez* decision, the law applying to the enforceability of arbitration agreements generally accommodated both the interests of plaintiffs who preferred arbitration as a means of dispute resolution as well as the interests of those who did not.¹⁶ Subsequent to *McMahon* and *Rodriguez*, however, investors who perceived arbitration to be an unsatisfactory means of resolving disputes with their brokers generally were unable to avoid the consequences of their predispute arbitration agreements.¹⁷ Thus, these decisions created a new concern about the arbitration system. This concern is not a function of the inherent nature of arbitration. This new concern arises from the foreclosure of choice for investors

14. For evidence of the efficiency and economy of securities arbitration, see *infra* text accompanying notes 34 & 36-37.

15. Investor discontent with securities arbitration has been discussed in the news media. See, e.g., Zigas, *Can't Sue Your Broker? It's No Big Loss*, *BUS. WK.*, June 22, 1987, at 128; Glaberson, *When the Investor Has a Gripe*, *N.Y. TIMES*, Mar. 29, 1987, § 3 at 1, col. 2.

16. Prior to *McMahon*, although there were a few decisions which suggested that arbitration could be compulsory, see, e.g., *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 221 (1985); *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 515-17 (1974), the majority position followed *Wilko v. Swan*, 346 U.S. 427, 438 (1953) (permitting customers to disregard arbitration agreements for claims arising from federal securities acts).

17. See *supra* note 12.

as to whether to engage the arbitration system. Formerly, investors could choose whether to submit their claims to arbitration and, thereby, to experience the disadvantages and advantages inherent in the nature of arbitration. After *McMahon* and *Rodriguez*, investors who have entered into predispute arbitration agreements with brokers have little choice but to submit to arbitration any disputes arising out of their customer/broker relationship. This article focuses on the question of how best to respond to this mandatory arbitration and on the attendant concerns of the investing public.¹⁸

II. PROBLEMS RESULTING FROM THE INCREASED USE OF MANDATORY ARBITRATION CLAUSES

The degree to which arbitration has or will become a mandatory system for resolving disputes is not merely a consequence of Supreme Court opinions permitting the enforcement of arbitration agreements;¹⁹ it also results from the pervasive brokerage industry practice requiring customers to enter into such arbitration agreements.²⁰ In 1987, three months after the Supreme Court decided *McMahon*, the SEC's Division of Market Regulation conducted a survey to determine how often brokers require arbitration commitments from their customers.²¹ The survey examined the

18. In responding to this concern, members of the North American Securities Administrators Association in October 1988 approved a resolution opposing mandatory arbitration of customer disputes with brokers. The group also proposed the adoption of a uniform state rule prohibiting mandatory arbitration. 20 Sec. Reg. & L. Rep. (BNA) No. 41, at 1599 (Oct. 21, 1988).

Federal legislators also have been sensitive to investors' concerns with mandatory arbitration. Two congressional sponsors of a bill designed to prohibit brokerage firms from imposing on their customers a policy of mandatory arbitration, see H.R. 4960, 100th Cong., 2d Sess. (1988), described customers as being shocked and surprised to discover, when conflicts arose with their brokers, that they no longer had recourse to the courts. 134 CONG. REC. E2233 (daily ed. June 30, 1988) (statement of Rep. Boucher) ("Thousands of investors with complaints . . . got a . . . rude shock when they learned, frequently to their surprise, that they would have no recourse other than arbitration."); 134 CONG. REC. E2245, E2246 (daily ed. June 30, 1988) (statement of Rep. Markey) ("Confronted with abuses of discretion, misexecution of orders, and other wrongs committed against them, [investors] were shocked to learn they had no recourse to the courts of law.").

19. *Rodriguez De Quijas v. Shearson/American Express, Inc.*, 109 S. Ct. 1917, 1922 (1989) (agreements to arbitrate 1933 Securities Act claims are enforceable under Federal Arbitration Act); *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 238, 242 (1987) (agreements to arbitrate 1934 Securities Act and Racketeer Influenced and Corrupt Organizations Act (RICO) claims are enforceable under Federal Arbitration Act).

20. See *infra* text accompanying note 44.

21. Securities and Exchange Comm'n, Div. of Market Regulation, Summary of Staff Findings With Respect to the Use of Predispute Arbitration Clauses (undated) [hereinaf-

practices of sixty-five broker dealers, including twenty-five of the largest member firms of the New York Stock Exchange (NYSE) and the twenty largest member firms of the National Association of Securities Dealers that are not NYSE members.²² The survey found that predispute arbitration agreements most frequently are required of customers with margin and option accounts. In the study, ninety-six percent of the margin accounts held by firms offering such accounts were covered by predispute arbitration clauses.²³ Ninety-five percent of retail option accounts held by firms that permit such options accounts were covered by arbitration agreements.²⁴ Only thirty-nine percent of cash accounts at the firms surveyed, however, were covered by arbitration agreements.²⁵ With respect to cash accounts, which typically give rise to fewer legal problems than margin or option accounts, only about sixty percent of the firms surveyed even required their customers to sign customer account agreements.²⁶ In the majority of instances when a customer account agreement was required, however, an arbitration agreement was contained therein.²⁷

The firms covered by the SEC survey were asked whether they would remove arbitration clauses at a customer's request. Four firms had written policies providing that the firm generally would not accept an account without the arbitration provision.²⁸ An additional fifteen firms had unwritten policies prohibiting waiver of the clauses.²⁹ In eleven other firms, customer requests to delete the arbitration provisions were resolved on a case-by-case basis by senior personnel.³⁰

Significantly, the SEC's survey found that firms intended to expand their use of arbitration clauses in response to recent judicial developments. Twenty-five of the sixty-five firms surveyed indicated that they either intended to adopt or were considering changes that would expand the number of accounts covered by an arbitration clause.³¹ Notably, six firms, representing forty-two percent of all

ter SEC Arbitration Clause Study], *reported in* 1 SECURITIES ARBITRATION COMMENTATOR, July 1988, at 6.

22. SEC Arbitration Clause Study, *supra* note 21, at 1.

23. *Id.* at 2.

24. *Id.*

25. *Id.*

26. *Id.* at 5.

27. *Id.*

28. *Id.* at 7.

29. *Id.*

30. *Id.* at 7.

31. *Id.* at 8.

NYSE retail cash accounts, stated that they either would use, or consider using arbitration clauses in cash accounts.³² Thus, in the one category of customer accounts for which brokerage firms historically had not required arbitration clauses, there was a significant trend toward their inclusion.³³

The *McMahon* and *Rodriguez* decisions, in conjunction with the industry's increased use of mandatory arbitration provisions, will result in greater industry reliance upon the arbitration mechanism to resolve customer/broker disputes. Customers therefore will have fewer opportunities to resolve disputes with brokers in judicial litigation, and arbitration ultimately may become a nearly universal dispute resolution mechanism for customer/broker controversies. Such increased reliance on arbitration will intensify public concern with the arbitration process and also will generate additional operational problems for the arbitration system. These operational problems could make arbitration less desirable as a dispute resolution device.

III. OPERATIONAL PROBLEMS RESULTING FROM A UNIVERSAL INDUSTRY PRACTICE OF CONDITIONING ACCESS TO BROKERAGE SERVICES UPON THE EXECUTION OF AN ARBITRATION AGREEMENT

Although arbitration offers participants certain benefits in terms of cost and time efficiency,³⁴ there are several factors indicating why an industry practice of requiring potential adversaries to arbitrate their disputes would be detrimental to the arbitration system and its users.

As an initial matter, a uniform industry practice compelling investors to enter into arbitration agreements to secure brokerage services would reduce the credibility of the arbitration system. It is axiomatic that customers are suspicious of goods or services which they are required to purchase or use as a condition to obtaining

32. *Id.*

33. *Id.* at 5.

34. While it is commonly believed that arbitration generally is faster and less expensive than litigation, few studies have examined these issues in regard to securities industry arbitration. The NYSE recently commissioned the accounting firm of Deloitte Haskins & Sells (DH&S) to conduct a survey comparing arbitration and litigation. In 1988, DH&S completed a report from that survey. Letter from DH&S to James E. Buck, Senior Vice President and Secretary of the NYSE (undated) [hereinafter DH&S Arbitration Study] (available from the author) (referring to a study of six large retail brokerage firms). The study concluded that the average lawsuit costs a brokerage firm \$20,000 to defend as opposed to only \$8,000 for an average arbitration claim. *Id.* at Exhibit A.

other desirable goods or services. Critics of mandatory arbitration question why, if securities industry arbitration is as fair and protective of customer interests as the industry claims, compelled universal use of the system is necessary.³⁵ An effective system, beneficial to its customers, should attract voluntary customer use. Increased use of mandatory arbitration, however, may generate public skepticism and concern that securities arbitration favors the industry to the detriment of the customer.

Another significant consequence of mandatory arbitration is the negative effect on the industry's impetus to provide a dispute resolution forum more efficient and less expensive than litigation. At present, arbitrated customer/broker disputes generally are resolved more quickly than litigated disputes. A recent study sponsored by the NYSE found that the average customer/broker arbitration proceeding is completed nearly six months faster than the average litigated customer/broker claim.³⁶ Based on a sample of 243 cases, the study found that the average litigated dispute required 599 days to complete, while the average arbitration lasted 434 days.³⁷ The very fact that the NYSE considered it necessary to study the time benefit of arbitration over litigation demonstrates that the industry feels competitive pressure in regard to the efficient operation of its dispute resolution system. If the industry effectively eliminated the judicial litigation alternative, the competitive pressures to improve the time efficiency of arbitration proceedings would be greatly reduced. Similar arguments might be made in regard to competitive pressures to maintain the fairness and cost efficiency of arbitration. The NYSE study also analyzed the relative success of customers engaging in litigation and arbitration, comparing the amounts actually awarded to plaintiffs through each respective adjudicatory system as a percentage of the amounts claimed. On average, a claimant in arbitration received fifteen percent of the claim (for an average recovery of \$35,000) as opposed to a plaintiff in litigation who on average

35. Rep. Boucher, when introducing arbitration legislation in 1988, noted that "if arbitration is attractive to the consumer they will go to arbitration willingly. If the industry operated arbitration system cannot be shown to give the consumer a fair shake it is clearly unfair to mandate that they sign compulsory arbitration agreements as a condition for dealing in securities." 134 CONG. REC. E2233 (daily ed. June 30, 1988).

36. DH&S Arbitration Study, *supra* note 34, at Exhibit A. The NYSE emphasized this time efficiency aspect of arbitration in a recent letter to the SEC written in response to an earlier SEC letter concerning predispute arbitration agreements. Letter from James E. Buck, Senior Vice President and Secretary of the NYSE, to David S. Ruder, SEC Chairman (Oct. 14, 1988) [hereinafter NYSE Arbitration Explanation Letter] (available from author).

37. DH&S Arbitration Study, *supra* note 34, at Exhibit A.

recovered 2.6 percent of the claim (for an average recovery of \$25,000).³⁸ Promulgation by the NYSE of such statistics favoring recovery in arbitration indicates that the securities industry feels pressure to justify its mandatory arbitration practices.

Perhaps the most significant reason for the securities industry to reject a dispute resolution system that relies exclusively, or virtually exclusively, upon arbitration is that such a system would not provide internal guidance on the current status of the law relating to customer/broker relations. Such a system would also be incapable of advancing the law regarding customer/broker relations when such advancements are warranted. Securities industry arbitration does not incorporate the principle of *stare decisis*. A rule of precedent in arbitration would be virtually impossible to achieve because securities industry arbitration panels are not required to prepare written, reasoned explanations for decisions rendered.³⁹ Although arbitrators do not seek guidance from previous arbitration precedents to decide current issues, feedback regarding prior adjudications is critical to accommodate the decision-rendering operations of the arbitration panels and to assist the parties in preparing their written submissions and oral presentations. One basis for appealing an arbitration award is the judicially created rule that an award may be overturned if the arbitrators demonstrate "manifest disregard" for the law.⁴⁰ While the parameters of this standard of judicial review are uncertain,⁴¹ the standard is meaningless unless arbitrators use legal precedent in rendering awards.⁴² Such precedential gui-

38. *Id.*

39. *Wilko v. Swan*, 346 U.S. 427, 436 (1953).

40. *See id.* (the clear failure of arbitrators to decide in compliance with statutory provisions is grounds for vacating arbitration award); *Merrill Lynch, Pierce, Fenner & Smith v. Bobker*, 808 F.2d 930, 933-34 (2d Cir. 1986) (disregard by arbitrators of "well-defined, explicit and clearly applicable" governing law will constitute grounds for setting aside arbitration award).

41. *See Lipton, The Standard on Which Arbitrators Base Their Decisions: The SROs Must Decide*, 16 SEC. REG. L.J. 3 (1988). The debate is summarized in the article as follows:

[T]wo distinguishable interpretations regarding the meaning of the "manifest disregard" standard can be found in the language of various judicial decisions. On one hand, the standard can be interpreted to require that arbitrators comply with the law (although recognizing that mere errors of law will not constitute a basis for vacating an arbitration award). On the other hand, the standard may be interpreted to mean that arbitrators need not comply with the law but merely that their decisions not be offensive to the law.

Id. at 11.

42. In perhaps its most liberal characterization, Judge Mansfield of the Second Circuit explained "manifest disregard" of the law to require that:

[the arbitrator's] error must have been obvious and capable of being readily and instantly perceived by the average person qualified to serve as an arbitra-

dance presently is obtained from the reported cases generated by the judicial litigation system. If universal arbitration of broker/dealer controversies replaced judicial litigation, however, the arbitration system no longer would find the same precedential guidance from reported case law. New issues—*e.g.*, evaluating the suitability for accounts trading in index options, measuring the churning in equity options accounts, determining the impact of the Racketeer Influenced and Corrupt Organizations Act (RICO)⁴³ on broker/dealer activities—have been arising in the context of arbitrated and litigated customer/broker controversies. Those new questions cannot be answered in a consistent and predictable manner by an arbitration system which does not generate precedents. If universal use of predispute arbitration clauses reduces judicial litigation of customer/broker controversies to a trickle, the arbitration system will be unable to obtain the benefits of precedential guidance.

In conclusion, a universal securities industry practice requiring customers to enter into predispute arbitration agreements would create operational problems for the arbitration system and ultimately for the parties using the system. Such a practice would (1) reduce the credibility of the arbitration system, (2) reduce the industry's competitive impetus to maintain a fair and efficient arbitration system and most importantly, (3) deny the arbitration system the precedential guidance which it receives when it operates in conjunction with a judicial litigation system based upon *stare decisis*. Despite these drawbacks, the securities industry is indeed increasingly conditioning access to brokerage services upon the execution of arbitration agreements.⁴⁴ In fact, with regard to margin and option accounts, brokerage firms almost universally have imposed mandatory arbitration.⁴⁵ In light of the detrimental effect that universal mandatory arbitration will have on the public's reaction to arbitration as well as on the operation of the arbitration system, it is necessary to ask how the industry's trend toward the exclusive use of arbitration can be discouraged.

tor. Moreover, the term "disregard" implies that the arbitrator appreciates the existence of a clearly governing legal principle but decides to ignore or pay no attention to it.

Bobker, 808 F.2d at 933.

43. Pub. L. No. 91-452, tit. IX, 84 Stat. 941 (codified as amended at 18 U.S.C.A. §§ 1961-1968 (West 1984 & Supp. 1989)).

44. See generally SEC Arbitration Clause Study, *supra* note 21.

45. *Id.* at 2-3.

IV. DISCOURAGING A UNIVERSAL INDUSTRY PRACTICE OF USING PREDISPUTE ARBITRATION CLAUSES

Two models for discouraging or prohibiting the securities industry from universally requiring customers to execute predispute arbitration agreements are analyzed below. The first model relies upon a regulation prohibiting brokers from conditioning access to their services upon the signing of arbitration agreements.⁴⁶ The second model is based on a disclosure device to advise customers of the effect of executing an arbitration agreement⁴⁷ and of the nature of arbitration. Such disclosure would encourage competition among brokers in offering customers a choice of forum for resolving disputes with their broker.

A. Regulatory Prohibition

The regulatory prohibition approach was proposed in a federal bill which was introduced but not adopted during the second session of the one hundredth Congress.⁴⁸ That approach also was taken in regulations adopted by Massachusetts, but enforcement of the regulations was enjoined by a federal district court.⁴⁹ The federal legislation would have prohibited brokers from entering into any predispute arbitration agreement with a customer unless the agreement was structured in accordance with procedures adopted by the SEC.⁵⁰ It was proposed that the SEC's rules, at a minimum,

46. This model is based on proposed federal legislation, as well as on regulations promulgated in Massachusetts. See *infra* notes 48-49 and accompanying text.

47. See *infra* text accompanying notes 66-73.

48. H.R. 4960, 100th Cong., 2d Sess. (1988).

49. *Securities Indus. Ass'n v. Connally*, 703 F. Supp. 146, 161 (D. Mass. 1988), *aff'd*, 883 F.2d 1114 (1st Cir. 1989). On September 22, 1988, the Massachusetts Secretary of State promulgated regulations, to become effective on January 1, 1989, which essentially would have banned mandatory arbitration practices by Massachusetts registered broker dealers. MASS. REGS. CODE tit. 950, § 12.204(G)1.a to c (1988). For the pertinent text of the regulations, see *infra* note 52. The regulations subsequently were found to be preempted by the Arbitration Act and their enforcement was enjoined by the United States District Court for the District of Massachusetts. *Connally*, 703 F. Supp. at 161.

50. The relevant portions of H.R. 4960 read as follows:

SECTION. 1. SHORT TITLE.

This Act may be cited as the "Securities Arbitration Reform Act of 1988."

SEC. 2. MINIMUM STANDARDS FOR ARBITRATION AGREEMENTS;
RULEMAKING AUTHORITY.

Section 15(c) of the Securities Exchange Act of 1934 (15 U.S.C. § 78o(c)) is amended by adding at the end thereof the following:

"(7)(A) No broker, dealer, or municipal securities dealer shall enter into any agreement with a customer to arbitrate future disputes that may arise between the broker, dealer, or municipal securities dealer and the customer unless such agreement is entered into in accordance with procedures prescribed

require that agreements to arbitrate: (1) be on separate pages and be separately executed; (2) not be made a condition for entry into an account agreement or be the basis for any fee differential; and (3) prominently disclose to customers information that would inform the customer of the consequences of entering into an arbitration agreement. Agreements made in contravention of such rules would be void. The proposed statute effectively would have prohibited mandatory arbitration provisions and also would have prevented brokerage firms from charging higher commissions to customers who did not agree to commit to arbitration.⁵¹

The Massachusetts ban on mandatory predispute arbitration agreements, introduced in September 1988, made the brokerage practice of requiring customers to enter into predispute arbitration clauses a ground for denial, revocation or suspension of a broker's registration with the State.⁵² The regulation made it a "dishonest or

by the Commission to afford the customer the opportunity to make an informed and voluntary decision to enter into such agreement.

"(B) The Commission shall, by rules, prescribe procedures to carry out the requirements of subparagraph (A) of this paragraph. Such rules shall, at a minimum, require the following:

"(i) Any agreement to arbitrate future disputes shall be on a separate page and shall be separately signed.

"(ii) Any agreement to arbitrate future disputes shall not be made a condition for entry into a customer account agreement, or be used as a basis for any fee differential, or for granting, denying, conditioning, or limiting access to any privilege, benefit, or service to the customer.

"(iii) Any agreement to arbitrate future disputes shall clearly and prominently disclose to the customer, in a form prescribed by the Commission, such information concerning the consequences of entering into the agreement as the Commission considers necessary or appropriate to the exercise of an informed and voluntary decision by the customer to enter into such an agreement.

"(C) Any such agreement that has not been entered into in accordance with procedures prescribed by the Commission pursuant to this paragraph shall be void."

H.R. 4960, 100th Cong., 2d Sess. (1988).

51. *Id.*

52. The Massachusetts regulations read as follows:

(G) *Dishonest or unethical practices in the securities business.*

1. *Broker-dealers.* Each broker-dealer shall observe high standards of commercial honor and just and equitable principles of trade in the conduct of its business. Act [sic] and practices including but not limited to the following, are considered contrary to such standards and constitute dishonest or unethical practices which are grounds for denial, suspension or revocation of registration or such other action authorized by law:

a. Requiring on or after January 1, 1989, that a customer located in Massachusetts, other than a customer that is an institutional investor or financial institution specified in 950 CMR 14.401(e), execute either a mandatory predispute arbitration contract or a customer agreement containing a mandatory

unethical" practice for brokers to require customers, other than institutional investors or financial institutions, to execute mandatory arbitration clauses as a nonnegotiable precondition to effecting transactions in securities.⁵³

The approach taken by both the proposed federal legislation and the state regulation essentially would prohibit brokers from requiring customers to agree, prior to a conflict, to arbitrate disputes with their brokers. Affected brokers would be unable to realize the cost savings arising from a dispute resolution system that exclusively utilized arbitration. Further, the regulatory prohibition approach would run counter to the goals of the national market system (NMS).⁵⁴ The goals of the NMS include obtaining efficient and best-price execution of securities transactions by linking the different securities markets and by promoting competition among the various components of the securities markets.⁵⁵ An identified objective of the NMS is "fair competition among brokers and dealers."⁵⁶ The regulatory prohibition approach to mandatory predispute arbitration agreements, however, would restrict the ability of brokers to effectively compete with one another for customer business on the basis of price and services. That restriction on competition would lead to a lesser variety of services available to the public. The restriction on competition among brokers that would result from the regulatory prohibition approach as well as the corresponding dimin-

pre-dispute arbitration clause that is a non-negotiable precondition to effecting transactions in securities for the account of the customer or opening a securities cash account or margin account by the customer with such broker-dealer;

b. Requesting on or after January 1, 1989, that a customer located in Massachusetts execute either a mandatory pre-dispute arbitration contract or a customer account agreement containing a pre-dispute arbitration clause where the contract or agreement fails to conspicuously disclose that the execution of the contract or agreement cannot be made a non-negotiable precondition to the opening by the customer of a securities account with the broker-dealer;

c. Requesting on or after January 1, 1989, that a customer located in Massachusetts execute either a mandatory pre-dispute arbitration contract or a customer account agreement containing a pre-dispute arbitration clause without fully disclosing to the customer in writing the legal effect of the pre-dispute arbitration contract or clause.

MASS. REGS. CODE tit. 950, § 12.204(G)1.a to c (1988).

53. *Id.* § 12.204(G)1.a.

54. The national market system (NMS) is the trading system that was to result from the regulatory and technological integration of the national securities markets as mandated by the 1975 Securities Reform Act which amended the 1934 Act. 15 U.S.C. §§ 77-78III (1975). The 1934 Act, as amended in 1975, specifically directs the SEC to facilitate the establishment of an NMS. *Id.* § 78k-1(a)(2).

55. *Id.* § 78k-1(a)(1)(D).

56. *Id.* § 78k-1(a)(1)(C)(ii).

ishment of brokerage services available to customers would be inconsistent with the goals of the NMS.

The relative cost of litigation and arbitration is another factor to consider in determining how best to discourage a universal industry practice of using predispute arbitration clauses. The average customer/broker litigation costs a brokerage firm two and one-half times as much as the average arbitration of a comparable matter.⁵⁷ Cost savings from arbitration provide an operational advantage for brokerage firms that resolve customer disputes by arbitration. In a regulatory permissive environment—one that permits brokers to require mandatory arbitration—this operational advantage invites brokerage firms to compete on one of two alternative planes—one relating to arbitration operations and another relating to other firm operations. First, firms could maintain a practice of including mandatory arbitration provisions in the customer account agreements and use the resulting cost savings to reduce charges for services currently offered or to offer additional services at no additional cost. Such additional services could include expanded research services, financial planning guidance, and personalized investment advice. Firms that elect to compete on the basis of expanded services or reduced service costs will do so in the belief that greater revenues will be generated due to improved services or reduced costs, producing a net gain that overcomes any losses attributable to customer dissatisfaction with mandatory arbitration.

As an alternative competitive strategy for gaining increased customer business in a regulatory permissive environment, some brokerage firms will allow customers to choose the method for resolving disputes with their brokers (and thus forego the cost advantage of arbitrating all disputes). These firms will seek to maintain an acceptable level of profits by reducing litigation expenditures. Methods for reducing litigation expenditures might include: (1) increasing the efficiency of in-house legal operations and reducing unnecessary use of outside counsel, (2) being more amenable to settlement as a means of lessening legal expenditures, and (3) improving supervision of brokers to reduce disputes that give rise to litigation.

Thus in a regulatory permissive environment, it is economically sensible for brokerage firms to compete by expanding services and reducing costs as well as by permitting customers to choose the dispute resolution forum. If a firm chooses to compete as to alterna-

57. See *supra* note 34.

tive dispute resolution forums, then it must attempt to reduce litigation costs. In a regulatory prohibition environment—*i.e.*, one prohibiting mandatory arbitration—a firm must commit resources toward reducing litigation costs. Pressure on the firm to provide customers with alternative services and cost savings as compensation for a mandatory arbitration practice is removed because arbitration simply would not be permitted. The planes upon which brokerage firms would be likely to compete are reduced in a regulatory prohibition environment as opposed to in a regulatory permissive environment. That reduction in competition is inconsistent with the objectives of the NMS.⁵⁸ It probably would result in a reduced variety of brokerage services available to customers, as well as reduced brokerage competition as to the fees charged for such services.

In addition to the effects discussed above, a regulatory prohibition environment could reduce the number of brokers participating in the retail brokerage business and increase commission costs for all retail customers. Litigation is a more expensive means for brokerage firms to resolve disputes with customers than arbitration.⁵⁹ If brokerage firms were compelled to absorb those increased costs, it is probable that some firms would reduce or eliminate their retail operations and apply their capital to more profitable operations. Commission revenues represent a declining portion of total securities industry revenues. Operations such as principal trading by brokerage firms provide an increasingly larger percentage of industry revenues. Between 1973 and 1987 the percentage of industry revenues generated by commissions dropped from fifty-five percent to twenty-four percent.⁶⁰ As the securities industry becomes less dependent upon retail customer business, a number of firms may be unwilling to remain in this aspect of the business when confronted with increased operational costs.

As an alternative to cutting back on retail customer operations, brokerage firms might find themselves compelled to include in their commission charges the increase in operational costs that would result from a prohibition on mandatory arbitration provisions. If the prohibitions on mandatory arbitration include prohibitions on differential commission rates (linked to whether a customer chose to execute an arbitration provision), then the increased commission rates would be across the board. The 1988 federal legislative pro-

58. See *supra* text accompanying note 56.

59. See *supra* note 34 and accompanying text.

60. Wallace, *Pervasive Impact of 'Day Traders'*, N.Y. Times, Aug. 15, 1988, at D6, col. 3.

posal would have included a provision prohibiting differential commissions based upon a party's willingness to forego a litigation remedy.⁶¹ In a regulatory environment prohibiting differential commissions, customers would have no opportunity to weigh the financial worth of choosing a dispute resolution forum against the cost of the increased commission rate.

Ultimately, if the regulatory prohibition approach dramatically reduced the numbers of matters arbitrated in the securities industry, the industry's impetus to maintain an efficient and inexpensive alternative dispute resolution system would diminish. With limited numbers of customers seeking the benefits of arbitration, the industry might not be motivated to analyze and improve the system. Even the SEC paid relatively little attention to the specific operations of the securities industry arbitration system prior to the *McMahon* decision⁶² and the resulting unprecedented growth in the arbitration caseload. It was not until several months after the Supreme Court decided *McMahon* that the SEC issued its first comprehensive set of recommendations as to how the industry should improve its arbitration operations.⁶³ At that time, the industry's arbitration system had been operating under its uniform rules for a decade without any major operational evaluation by the SEC.⁶⁴ Diminished use of arbitration would not result in an abandonment of the arbitration alternative, but fewer industry and regulatory resources probably would be devoted to an activity that is underutilized as opposed to an activity that is well utilized.

B. Full Disclosure in Conjunction with Competition

An alternative to the regulatory prohibition model for avoiding

61. For the relevant text of H.R. 4960, 100th Cong., 2d Sess. (1988), see *supra* note 50.

62. From the point in 1977 when the Commission encouraged the securities industry to adopt a Uniform Code of Arbitration (Securities Exchange Act Release No. 13,470 [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,136 (Apr. 26, 1977)), until shortly after the *McMahon* decision was handed down, there is no record of the Commission staff systematically analyzing the operations of securities industry arbitration.

63. Letter from SEC Director of Division of Market Regulation to Various Self-regulatory Organizations Which Conduct Arbitration (Sept. 10, 1987) (available from author) (containing recommendations—based on a staff study of the arbitration system—for improving arbitration).

64. See *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 233-34 (1987). The Court noted that although the SEC had expansive powers to ensure the adequacy of the arbitration procedures employed by the self-regulatory organizations, the SEC thus far had refused to conduct an operational evaluation of the arbitration system. *Id.* at 233.

a universal industry practice of mandatory arbitration agreements is an approach requiring brokerage firms to disclose to customers the effect of executing an arbitration agreement. The disclosure device would advise customers of the nature of arbitration, and its very existence hopefully would stimulate brokerage firm competition in allowing the customer to choose the dispute resolution forum. Under this disclosure model, brokerage firms would be required to explicitly disclose to customers: (1) the limitations of arbitration as compared to litigation and (2) the fact that by signing an arbitration agreement, the customer forfeits the right to litigate disputes. Brokers would be permitted to deny their services to customers who rejected arbitration clauses. Customers, however, would be free to bargain with brokers regarding the inclusion of the arbitration clause in their account agreement.

The intended effects of disclosure would be to alert customers to the special nature of arbitration and to encourage brokerage firms to compete in regard to their mandatory arbitration practices. Firms that believe that they would have a competitive advantage over other firms in terms of their legal costs in litigation would offer their customers a choice in regard to their dispute resolution forum (forum-neutral firms). Other firms, believing that their operational strengths are found in areas other than efficient legal operations, would compete by modifying or expanding services unrelated to dispute resolution or by reducing fees. Firms that choose to compete through nondispute resolution services or fees would not be restricted in their competitive choice by the need to absorb the costs of litigating, as opposed to arbitrating, customer disputes. The competition arising because of disclosure would insure that mandatory arbitration would not be a universal industry practice. At the same time, the disclosure model, by allowing firms to choose in which areas to compete and by not requiring firms to absorb the costs of litigating customer disputes, would provide a greater variety of brokerage services and fees than the regulatory prohibition model.⁶⁵

The disclosure model, by focusing greater customer and industry attention on arbitration clauses, would stimulate competition among brokerage firms. Firms specifically would advise their customers that they forfeit certain advantages of litigation by signing an arbitration agreement. Such disclosure and customer assent re-

65. For a discussion of the regulatory prohibition model, see *supra* text accompanying notes 48-64.

quirements would result in certain customers, for whom it is economically worthwhile, bargaining with brokerage firms to omit the arbitration clause from the customer agreement. Predictably, some customers would "shop" for forum-neutral brokerage firms. This body of customers would insure that some brokerage firms would adopt the forum-neutral approach. A firm will elect to become (or remain) forum-neutral if the value of the increased business resulting therefrom exceeds the increased litigation costs resulting from being forum-neutral.

For disclosure to effectively stimulate competition among brokers in regard to a choice of dispute resolution forum, guidelines should be provided as to the minimum information that the firms must include in customer agreements containing arbitration provisions. The disclosure must alert customers to the differences between arbitration and litigation as well as to the consequences of executing an arbitration agreement. Self-regulatory organizations (SROs) that conduct securities arbitration proposed rules requiring such disclosure.⁶⁶ These rules were approved by the SEC in the Spring of 1989.⁶⁷ The SRO rules, as approved, identify the following information as necessary for disclosure: (1) the final and binding nature of arbitration,⁶⁸ (2) the fact that execution of an arbitration agreement results in a waiver of the parties' right to seek remedies in court including the right to a jury trial,⁶⁹ (3) the more limited nature of discovery in arbitration as compared to judicial litigation,⁷⁰ (4) the fact that arbitration awards need not include factual findings or the legal bases for the award,⁷¹ (5) the limited right of appeal of arbitration awards,⁷² and (6) the fact that arbitration panels typically will include a minority of arbitrators who are or were affiliated with the securities industry.⁷³ In addition to requiring specific disclosure information, the SRO rules also require the highlighting of the disclosed information within the customer agree-

66. For example, see notice of the proposed rules of the NYSE and NASD regarding disclosure of arbitration provisions and other matters dealing with arbitration, as well as amendments thereto published in 54 Fed. Reg. 15,860 (Apr. 19, 1989), 54 Fed. Reg. 9955 (Mar. 8, 1989), 54 Fed. Reg. 6224 (Feb. 8, 1989), 54 Fed. Reg. 3883 (Jan 26, 1989), and 53 Fed. Reg. 45,640 (Nov. 10, 1988).

67. Securities Exchange Act Rel. No. 34-26805 (May 10, 1989) [Current Binder], Fed. Sec. L. Rep. ¶ 84,414 [hereinafter New Arbitration Rules Release].

68. New Arbitration Rules Release, *supra* note 67, at 80,111-3.

69. *Id.*

70. *Id.*

71. *Id.*

72. *Id.*

73. *Id.*

ment as well as the highlighting of a statement, immediately preceding the signature line, to the effect that the agreement contains an arbitration agreement.⁷⁴ The Commission predicted that when the disclosure rules become effective,⁷⁵ they "should promote more knowledgeable acquiescence or rejection by customers of arbitration provisions."⁷⁶

Other disclosure provisions also could be added to the SRO rules to more completely describe the operation of the securities arbitration system. For example, some investors might find it important to know that—unlike the standard procedure used in commercial arbitration—the arbitrators for a securities hearing panel are chosen not by the parties but by the arbitration forum administrator. Also, the fact that arbitrators frequently are guided by commercial wisdom, and not by a rule of law, in resolving disputes could influence a person's decision to execute an arbitration agreement. In addition to the disclosure of information concerning the nature of arbitration, investors should be advised that there is no uniform securities industry practice concerning customer freedom of choice as to dispute resolution forum.⁷⁷ Such disclosure would alert customers that they need not execute an arbitration agreement with a firm requiring mandatory arbitration to obtain brokerage services. Then, each customer could evaluate whether the benefits of a choice of dispute resolution forum are sufficient to warrant the effort necessary to find a suitable "forum-neutral" broker. This advice to customers concerning the absence of a uniform mandatory arbitration agreement policy also would encourage the development of industry competition in permitting customers to choose a dispute resolution forum.

Under certain circumstances the disclosure model may prove ineffective. The securities industry might determine that the additional retail customer business obtainable through a forum-neutral policy would not offset the additional litigation costs resulting from such a policy—the result being a uniform mandatory policy. Disclosure then would prove to be an ineffective means for providing customers a choice of dispute resolution forum. At that point, the

74. *Id.*

75. The disclosure rules were approved by the Commission on May 10, 1989, and became effective 120 days later. *Id.* at 80,114 n.61.

76. *Id.* at 80,113.

77. The Commission reported that "[a]t least five of the nation's largest broker-dealers, with offices around the country . . . do not require the signing of account agreements for individual cash accounts that do not otherwise require documentation in connection with other services provided in the account." *Id.* at 80,111-3 n.51.

industry's oversight bodies would need to reconsider adopting the regulatory prohibition approach. The regulatory prohibition approach, however, has the disadvantages of reducing the variety and availability of brokerage services and increasing the cost of brokerage services.⁷⁸ Thus, brokers should not be regulatorily prohibited from conditioning the provision of services on customers' agreeing to arbitration, unless it is demonstrated that industry competition regarding a forum-neutral policy will not develop in response to the new disclosure provided to customers.

V. SUMMARY

Securities industry arbitration is thought to be a more efficient and expeditious method of dispute resolution than litigation.⁷⁹ Certain operational limitations, however, are inherent in the nature of arbitration.⁸⁰ Historically, securities industry customers, even after executing predispute arbitration agreements, could weigh the benefits of arbitration against its limitations and then decide whether to arbitrate or litigate claims against their brokers.⁸¹ *McMahon* and *Rodriguez* virtually eliminated this freedom of forum choice for customers who have executed arbitration agreements.⁸² The absence of choice in regard to a dispute resolution forum presents problems for investors who would prefer to litigate these claims. Increasing use of mandatory arbitration agreements within the securities industry intensifies these problems for investors.

Universal mandatory arbitration creates problems for the securities industry as well as for individual customers. Mandatory arbitration (1) reduces confidence in the industry arbitration system,⁸³ (2) diminishes the industry's impetus to maintain and improve the efficient operation of the system,⁸⁴ and most significantly, (3) ultimately will severely restrict—if not eliminate—the precedential feedback from judicial litigation.⁸⁵ This feedback is essential to parties pre-

78. For a discussion of the regulatory prohibition model, see *supra* notes 48-64 and accompanying text.

79. See *supra* text accompanying notes 14-18.

80. *Id.*

81. See *supra* text accompanying note 14.

82. See *Rodriguez De Quijas v. Shearson/American Express, Inc.*, 109 S. Ct. 1917, 1919-21 (1989); *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 238 (1987).

83. See *supra* text accompanying note 35.

84. See *supra* text accompanying note 38.

85. See *supra* text accompanying notes 40-43.

paring arbitration cases and to the reasoned formation of arbitration awards.

Thus, a universal mandatory arbitration practice would have identifiable negative results. Two models are evaluated herein as possible responses to the potential universal industry practice. The first model—regulatory prohibition—was proposed in Congress and was adopted by at least one state regulatory body.⁸⁶ The other model—disclosure in conjunction with competition—has been proposed by securities industry SROs and approved by the SEC.⁸⁷ Both approaches are intended to eliminate an industry practice of universal mandatory arbitration. The regulatory prohibition model has the disadvantage of discouraging competition among brokers in regard to services offered to customers. Limiting competition is inconsistent with the goals of the NMS.⁸⁸ In addition the regulatory prohibition approach might well reduce the number of brokers willing to conduct a retail brokerage business. Finally, the regulatory prohibition model could reduce industry use of arbitration, thereby limiting the industry's willingness to maintain and improve the arbitration system as an attractive alternative to judicial litigation. The disclosure in conjunction with competition approach does not suffer from these disadvantages. Rather, the disclosure approach encourages competition among firms.

For these reasons disclosure in conjunction with competition is the model of choice for avoiding a universal or nearly universal industry practice of conditioning brokerage services upon the execution of an arbitration agreement. The success of this approach, however, depends on the development of industry competition in regard to permitting customers to choose a dispute resolution forum. Now that this approach has been implemented, its effects should be studied to determine if the desired competition results.

86. *See supra* notes 50-52.

87. *See supra* text accompanying notes 66-76.

88. *See supra* notes 54-56 and accompanying text.