Securities law and arbitration: Courts uphold validity of predispute arbitration agreements in spite of securities laws

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SECURITIES LAW AND ARBITRATION: COURTS UPHOLD VALIDITY OF PREDISPUTE ARBITRATION AGREEMENTS IN SPITE OF SECURITIES LAWS

by MARGO E.K. REDER

I. INTRODUCTION

This note explores the alternative dispute resolution technique of arbitration as it is employed in securities disputes. Historically, such disputes have been resolved in judicial forums, but increasingly courts are compelled to turn over such cases to arbitration associations. In the typical scenario involving arbitration of securities disputes, the investor/customer loses money on an investment in publicly traded securities, and later brings an action in federal district court attempting to recoup losses. The brokerage house will then seek a stay of the litigation, and an order compelling arbitration as per the predispute arbitration agreement executed by the parties upon the opening of the account.

II. THE CONFLICT

The allegations are usually for excessive trading ("churning" of customer accounts), fraud and misrepresentations, unauthorized trading, racketeering activity, as well as deceptive and unfair trade practices. For such violations, the customer seeks to recover damages under the following: Section 12(2) of the Securities Act of 1933 (Securities Act),\(^1\) Section

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10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 (Exchange Act),\(^2\) the Racketeer Influenced and Corrupt Organizations Act (RICO),\(^3\) or possibly on a pendent state law theory such as unfair trade practices.\(^4\) Under each of these causes of action, there exists the right of a private remedy—the right to resolve allegations in a judicial forum. Each theory allows the customer's standing in state and/or federal court to resolve the controversy.\(^5\)

The customer however, has signed the brokerage firm's standardized agreement as a precondition to trading in securities.\(^6\) Customer agreements in virtually all instances contain a predispute arbitration clause providing that any controversy relating to the account shall be settled by arbitration, in accordance with the rules of an agreed upon exchange or association.\(^7\) The arbitration clause is construed as a con-
tract, with each party promising to settle controversies arising under the broker-customer relationship in an arbitral, rather than judicial forum.  

Therein lies the conflict: the customer, in order to invest in publicly traded securities, must surrender the right to pursue Congressionally created causes of action in court, and is forced to seek redress in arbitration.  

III. ARBITRATION

Arbitration has been defined as the process of submitting a disagreement to one or more agreed upon impartial persons with the understanding that the parties are bound by the decision.  

This alternative dispute resolution technique was historically met with hostility by jurists.  

Only in 1925 did Congress address the issue of arbitration by enacting the Federal Arbitration Act (FAA) with two goals in mind: to avoid the costliness of litigation; and to place arbitration agreements on the same footing as other private contracts.  

The FAA provides that agreements AAA or NYSE rules as customer elects).  

See generally Di Fiore, Problems in Alternative Dispute Resolution: Arbitration Agreements as Contracts of Adhesion in Consumer Securities Dispute, 93 COM. L.J. 259, 259 (1988) (brokerage firms avoid litigation costs by requiring arbitration of disputes); letter from David S. Ruder to Joseph R. Hardiman at 2 (July 8, 1988) (serious policy questions exist when brokerage industry conditions access to its services on execution of mandatory arbitration clauses). Chairman Ruder noted that 96% of margin accounts, 95% of options accounts, and 39% of cash accounts currently contain predispute arbitration clauses.  

See supra note 7 and accompanying text (discussing contents of customer agreements); see also Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2332, 2337 (1987) (Federal Arbitration Act requires enforcement of arbitration agreements even if claim founded on statutory right, unless contract resulted from fraud). The practical effect, therefore, is to deny customers their right to standing in court.  

This is true in spite of the fact that the Securities, Exchange, and RICO Acts allowing customers to sue in court for securities violations, were enacted after the Federal Arbitration Act.  

See R. COULSON, BUSINESS ARBITRATION: WHAT YOU NEED TO KNOW 12 (1980) (arbitration agreement binding commitment by both to resort to arbitration in disputes or to clarify meaning or application of contract); BLACK'S LAW DICTIONARY 96 (5th ed. 1979) (arbitration is submission of dispute to private unofficial parties).  


to arbitrate even statutory claims are enforceable, so that litigation must be stayed during which time the court shall order the parties to arbitration.\textsuperscript{13} This federal policy favoring arbitration may be defeated only upon evidence of fraud or overreaching, or by a contrary Congressional command.\textsuperscript{14} The FAA is codified at 9 U.S.C.A. §§ 1-14 (West 1981 & Supp. 1988).\textsuperscript{15}

Predispute arbitration agreements usually allow customers the option to bring claims before the American Arbitration Association (AAA) or before one of the securities industry's self-regulatory organizations (SRO's).\textsuperscript{16} The procedures are generally similar. Commentators believe that arbitrators are likely to be more knowledgeable than judges in securities law.\textsuperscript{17}

Under the AAA securities arbitration rules, one arbitrator, who is chosen by the parties, decides cases when the claim is for less than $20,000.\textsuperscript{18} If the dispute is for a greater amount, three arbitrators are chosen for the case.\textsuperscript{19} In smaller cases, the arbitrator may not be affiliated with the securities industry.\textsuperscript{20} In larger cases, not more than one arbitrator


\textsuperscript{14} Id. 2337-38 (fraud or excessive economic power invalidates arbitration argument as does clear Congressional directive to make exception to FAA). \textit{But see id. at 2350 (Blackmun, J., dissenting)} (Court correctly states exceptions to FAA, but then fails to acknowledge that Exchange Act, like Securities Act constitutes such an exception which is discernible from statutes text and legislative history).

\textsuperscript{15} Section 1 provides the general enabling language. 9 U.S.C.A § 1 (West 1981 & Supp. 1988). Section 2 provides that any provision to settle by arbitration a controversy arising thereunder is valid under contract law theory. \textit{Id.} § 2. Section 3 provides that any litigation over issues referable to arbitration shall be stayed until the arbitration is completed. \textit{Id.} § 3. Section 4 provides that the arbitration agreement may be enforced by petitioning a federal district court. \textit{Id.} § 4. Section 5 provides for the appointment of an arbitrator. \textit{Id.} § 5 Sections 6-14 are provisions relating to procedures to be followed under the FAA. \textit{Id.} §§ 6-14.

\textsuperscript{16} See generally Rodríguez De Quijas v. Shearson/Lehman Bros., Inc. 845 F.2d 1296, 1297 n.2 (6th Cir. 1988) (arbitration shall be in accordance with rules of NASD, NYSE, or AMEX); Friedman, \textit{Arbitrating Your Case Under the Securities Rules of the AAA}, 43 ARB. J. (No. 2) 23, 26 (1988) (customer typically has option to pursue claim before AAA or an SRO).


\textsuperscript{18} See Friedman, \textit{supra} note 16, at 28.

\textsuperscript{19} See Friedman, \textit{supra} note 16, at 28.

\textsuperscript{20} See Friedman, \textit{supra} note 16, at 28.
may be affiliated with the securities industry. An affiliation with the securities industry has generally been defined as “persons who have been directly or indirectly within the last five years employed by or acted as counselors, consultants, or advisors to any securities organization or affiliate.”

A 1985 AAA survey of forty cases found that twenty-seven of these resulted in customer awards, with four awards of punitive damages. The National Association of Securities Dealers (NASD) has reported awards to customers in fifty-five percent of its cases.

Securities arbitration awards are typically made without explanation of principles of law which may have been applied. This has prompted much criticism of the arbitration system. Although the McMahon Court observed that judicial review of arbitration awards is sufficient to ensure that arbitrators comply with the Securities and Exchange Acts, questions remain. The arbitration system does not provide oversight as to relevant issues or as to information that may or may not be presented. Further, judicial grounds for vacating an arbitration award are severely limited. Vacating decisions upon a showing of “manifest disregard” for the law means that arbitrators do not have to strictly comply with the securities laws. Arbitrators, therefore, are not as accountable for decisions as their judicial counterparts.

IV. CASE LAW

Courts’ attempts to reconcile the FAA with the Securities and

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21 See Friedman, supra note 16, at 28.
22 See Friedman, supra note 16, at 29; see also infra note 109 and accompanying text.
23 See Bedell, Harrison & Harvey, supra note 17, at 9; see also infra note 110 and accompanying text.
24 See Bedell, Harrison & Harvey, supra note 17, at 9; Securities Industry Conference on Arbitration (SICA) Rept. No. 5, at 6 (April, 1986); see also infra note 110 and accompanying text.
26 Id. at 2340 (judicial scrutiny necessarily limited but sufficient). But see id. at 2354-55 (Blackmun, J., dissenting) (judicial scrutiny insufficient).
27 See Lipton, supra note 25, at 13.
Exchange Acts have been both frequent and inconsistent. The Court first addressed this issue thirty-six years ago in Wilko v. Swan.

Wilko brought suit in federal district court against a securities brokerage firm. The customer sought to recover damages under §12(2) of the Securities Act, alleging that the brokerage firm defrauded him in the purchase of common stock. Notably, the SEC participated as amicus curiae, and shared the customer's burden in presenting the case to the Court. Pursuant to the parties' predispute arbitration agreement the broker moved to stay litigation until the matter had been arbitrated.

Finding that the predispute agreement to arbitrate was a 'stipulation' under §14 of the Securities Act, and that the right to select a judicial

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30 346 U.S. 427 (1953). The Court granted certiorari to review the "important and novel federal question affecting both the Securities Act and the United States Arbitration Act." Id. at 430.

31 Id. at 428.


33 See Wilko v. Swan 346 U.S. 427, 428 (1953). This, of course, is completely at odds with the SEC's present position which endorses wholeheartedly the concept of securities arbitration. See Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2332, 2356 & n.21 (1987) (Blackmun, J., dissenting) (SEC's position, until it filed amicus brief in McMahon, was consistent with Wilko); see also infra notes 112-113 and accompanying text (discussing SEC's position).


35 See 15 U.S.C.A. § 77n (West 1981 & Supp. 1988) (§ 14 provides that any stipulation, provision requiring security buyer to waive compliance with any part of Securities Act shall be void). The Court reasoned that since the Securities Act provided defrauded purchasers the right to maintain an action in any court, an agreement to arbitrate such disputes impinged on this Congressionally granted right. See Wilko v. Swan, 346 U.S. 427, 494-35 (1953).
forum was the kind of provision which could be waived under § 14, the Court invalidated the parties' agreement to arbitrate.\textsuperscript{36} The Court tried to reconcile the policies of both Congressional acts, and decided that the intent of Congress regarding the sale of securities was better effectuated by staying the arbitration.\textsuperscript{37}

While the Court acknowledged that Congress sought to present arbitral forums as a speedier, less expensive alternative, it felt that securities disputes were inherently more complex than other disputes, and that securities customers operated under unique disadvantages.\textsuperscript{38} Further, the Court considered that arbitral forums lacked suitable oversight and safeguards to ensure a fair and just resolution of the issues.\textsuperscript{39} Claims under the Securities Act, therefore, could be litigated notwithstanding the presence of a predispute arbitration agreement.\textsuperscript{40} The Court treated harshly the process of arbitration, implying that it was useful only for simple disputes, and called into question the procedures used in arbitration.

\textsuperscript{36} Id. The Court refused to allow securities customers the option of bargaining away their right to litigate claims. \textit{Id. Cf.} Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2332, 2343 (1987) (enforcement of predispute arbitration agreement does not effect waiver of compliance with Exchange Act provisions). \textit{But see} Rodriguez De Quijas v. Shearson/Lehman Bros., Inc., 845 F.2d 1296, 1299 (5th Cir. 1988) (arbitration of Securities Act claims mandatory).


\textsuperscript{39} \textit{See} Wilko v. Swan, 346 U.S. 427, 436-37 (1953) (arbitrator's power almost unlimited, and judicial review extremely limited); Di Fiore, \textit{supra} note 7, at 262 (Court reasoned Securities Act's protective provisions required judicial rather than arbitral resolution). Lipton, \textit{supra} note 25, at 13-14 (securities arbitration awards made without explanation or enunciation of principles of law and judicial oversight lacking). \textit{But see} Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2332, 2340 (judicial review sufficient to ensure arbitrators comply with requirements of statute).

\textsuperscript{40} Wilko v. Swan 346 U.S. 427, 438 (1953); \textit{see also} Chang v. Lin, 824 F.2d 219, 222 (2d Cir. 1987) (customer has right to litigate Securities Act claims in spite of predispute arbitration agreement); Ketchum v. Almahurst Bloodstock IV, 685 F. Supp. 786, 793 (D. Kan. 1988) (court refused to restrict customer's right to litigate Securities Act claims). \textit{But see} Rodriguez De Quijas v. Shearson/Lehman Bros., Inc., 845 F.2d 1296, 1298 (5th Cir. 1988) (McMahon reasoning has undermined Wilko).
The next major arbitration case before the Court was Scherk v. Alberto-Culver Company. The Court considered the validity of a predispute arbitration clause in the context of Exchange Act violations in an international business transaction. Declining to follow the exception to the FAA "carved out by Wilko," the Court upheld the parties pre-dispute arbitration agreement, reasoning that policy concerns were totally different in the international business arena. The Court, even at this stage, had begun to distance itself from Wilko in its oft-quoted observation that "a colorable argument could be made that even the semantic reasoning of the Wilko opinion does not control the case before us." The Court distinguished the Exchange Act from the Securities Act, noting that the provisions under the former are much more narrow than under the latter. Finally, the Court reasoned that arbitration clauses in international agreements were indispensable to the achievement of predictability in determining the applicable law.

The next two Supreme Court cases addressing arbitration clauses seem quite a departure from the suspicions expressed in Wilko. Dean Witter Reynolds, Inc. v. Byrd involved a broker-customer dispute, although the issue centered on the arbitrability of pendent state claims. Byrd alleged...
that Dean Witter engaged in excessive trades, many done without consent, and that misrepresentations were made.\textsuperscript{50} Taking the opportunity to note that many lower courts applied \textit{Wilko} to Exchange Act claims thereby disallowing arbitration agreements, the Court declined to resolve that question which was not directly before it.\textsuperscript{51} Instead, a unanimous Court concluded that the strong federal policies reflected in the FAA require arbitration of pendent arbitrable claims even if the proceedings would become bifurcated.\textsuperscript{52}

\textit{Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.}\textsuperscript{53} involved claims arising under the Sherman Act, but this opinion paved the way for \textit{McMahon} and further placed in doubt the vitality of \textit{Wilko}.\textsuperscript{54} The \textit{Mitsubishi} Court found that even Sherman Act claims were arbitrable pursuant to the FAA, due to the "emphatic federal policy in favor of arbitral dispute resolution."\textsuperscript{55} The Court declared it was "well past the time when judicial suspicion of . . . arbitration . . . inhibited the development of arbitration."\textsuperscript{56}

The most recent guidance from the Supreme Court was given in the June, 1987 decision of \textit{Shearson/American Express, Inc. v. McMahon}.\textsuperscript{57} The McMahons proved, \textit{inter alia}, fraud by Shearson under Section 10(b) and Rule 10b-5 of the Exchange Act.\textsuperscript{58} Noting the conflict among circuit

\textsuperscript{50} Id. at 214.
\textsuperscript{51} Id. at 215-16 & n.1. Indeed, the securities industry urged the Court to resolve the applicability of \textit{Wilko} to Exchange Act claims. Id. Many of the circuit courts believed that \textit{Wilko} applied the Exchange Act claims already. See \textit{Shearson/American Express, Inc. v. McMahon}, 107 S. Ct. 2332, 2359 (1987) (Stevens, J., concurring in part and dissenting in part) (following \textit{Wilko}, each circuit addressing issue applied it to Exchange Act claims).
\textsuperscript{53} 473 U.S. 614 (1985).
\textsuperscript{54} Id. at 616-19. The Court relied heavily upon \textit{Mitsubishi} in its \textit{McMahon} decision. See \textit{Shearson/American Express, Inc. v. McMahon}, 107 S. Ct. 2332, 2336-37, 2339-41, 2344-45 (1987).
\textsuperscript{55} \textit{Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.}, 473 U.S. 614, 631 (1985). The Court mandated arbitration of federal statutory rights even though an explicit private right of action existed. \textit{Id}.
\textsuperscript{56} \textit{Id.} at 626-27. \textit{Compare} \textit{Wilko} v. Swan, 346 U.S. 427 (1953) (Court concluded arbitration adequate for only simple proceedings and failed to envisage arbitration of complex statutory disputes).
\textsuperscript{57} 107 S. Ct. 2332 (1987). The Court granted \textit{certiorari} to determine whether claims brought under the Exchange Act, as well as those brought under the RICO Act must be arbitrated in accordance with the terms of their agreement. \textit{Id.} at 2335, 2336-37. \textit{Cf. Securities Industry Assoc. v. Connolly}, 17 M.L.W. 693 (Dec. 26, 1988) (Massachusetts State securities regulations preempted by FAA as interpreted by Court).
\textsuperscript{58} \textit{Shearson/American Express, Inc. v. McMahon}, 107 S. Ct. 2332, 2336 (1987). \textit{See supra} note 2 and accompanying text (discussing contents of section 10(b) and Rule 10b-5).
courts, the Court upheld the validity of predispute arbitration agreements as applied to controversies under the Exchange Act.\textsuperscript{59} This important opinion, written by Justice O'Connor for a badly split and transitional Court, has received widespread notice by commentators, the security industry, and its regulators.\textsuperscript{60}

The Court first pointed out that the FAA mandates judicial enforcement of agreements to arbitrate statutory claims absent a contrary congressional demand.\textsuperscript{61} Second, the Exchange Act's nonwaiver provision does not include its jurisdictional provisions providing district courts with the exclusive right to hear violations thereunder.\textsuperscript{62} The Court reasoned that the waiver clause prohibits waiver of substantive obligations, and that jurisdictional provisions do not in their nature require such compliance.\textsuperscript{63} The Court thereby pared down Wilko, declaring that it now merely stands for the proposition that waiver of the right to select a judicial forum "was unenforceable only because arbitration [in 1953] was

\textsuperscript{59} Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2332, 2336-37 & n.1. See also id. at 2343 (agreement to arbitrate Exchange Act claims enforceable as per explicit provisions of FAA). \textit{But see} id. at 2350 (Blackmun, J., dissenting) (Exchange Act, like Securities Act exception from mandate of FAA). The Court thereby agreed with the first, third, and eighth circuits, and disagreed with the second, fifth, sixth, ninth, and eleventh circuits. \textit{Id. at} 2337 n.1. \textit{See also} Osterneck v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 841 F.2d 508 (3d Cir. 1988).

\textsuperscript{60} The Court unanimously agreed that civil RICO claims are arbitrable. \textit{See} Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2332, 2343-46 (1987). However, it split 5-4 on the issue of arbitrability of Exchange Act claims. \textit{Id. at} 2343, 2346 (Blackmun, J., dissenting); and 2359 (Stevens, J., dissenting). Justice O'Connor was joined by Chief Justice Rehnquist, and Justices White, Powell, and Scalia. Justice Blackmun was joined by Justices Brennan and Marshall. Since this opinion Justice Kennedy replaced retired Justice Powell; and Chief Justice Rehnquist had just one year as head of the Court. Additionally, three of the four dissenters: Justices Brennan, Blackmun, and Marshall, widely regarded as the liberal core of the Court, are now in their 80's. President Bush, therefore will likely be able to nominate a few Supreme Court Justices during his tenure.

\textit{McMahon} has been written about widely. \textit{See, e.g., Note, supra note 38, at 193; Bedell, Harrison & Harvey, supra note 17, at 1; Note, supra note 17, at 1. The securities industry viewed McMahon as a major victory. \textit{See} N.Y. Times, Nov. 15, 1988, \textsection D1, col. 8 (McMahon outstanding victory for securities firms). Moreover, the SEC initiated a review of self-regulatory organization (SRO) arbitration since the decision. \textit{See} letter from Richard G. Ketchum to James E. Buck (Sept. 10, 1987) (need for thorough review of arbitration in light of McMahon).


\textsuperscript{62} \textit{Id. at} 2338. \textit{See also} 15 U.S.C.A. \textsection 78cc(a) (West 1981 & Supp. 1988) (Any condition, stipulation, provision binding anyone to waive compliance with any rule or regulation void).

judged inadequate to enforce Securities Act rights.”

Third, the Court disagreed with the customers’ arguments that mandatory arbitration of Exchange Act claims weakens their ability to recover for violations thereof. The Court systematically rejected each of the grounds cited by Wilko in its decision favoring judicial resolution of Securities Act claims. Justice O’Connor then proceeded to enthusiastically describe the virtues of arbitration and “refuse[d] to extend Wilko’s reasoning to the Exchange Act in light of the intervening ... developments.”

Lastly, the Court found that the 1975 Congressional amendments to the Exchange Act were not dispositive on the issue of arbitrability of Exchange Act claims, and that “the Wilko issue was left to the courts.”

Justice Stevens, in a separate opinion, strongly disagreed with this last conclusion arguing that the Court departed from a settled construction of the Exchange Act. The Justice concluded that such a different

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"Id. at 2339 (Wilko bars waiver of “judicial forum only where arbitration is inadequate to protect the substantive rights at issue”). (Emphasis added.) The Court, later in its opinion, admitted McMahon is difficult to reconcile with Wilko. Id. at 2341.

"Id. at 2339-40. Absent a predispute arbitration clause, Exchange Act violations may be vindicated in federal district courts which have exclusive jurisdiction over such claims. See 15 U.S.C.A. § 78aa (West 1981 & Supp. 1988) (federal courts shall have exclusive jurisdiction to hear allegations of Exchange act violations).


"Id. at 2342-43 (contrary to customers’ argument that amendments voided such agreements, Congress simply meant to enhance self-regulatory function of SRO’s). The Court declined to read any substantive meaning into the Conferree’s statement that “this amendment did not change existing law as articulated in Wilko. . . . ” Id. at 2343. See also H.R. Rep. No. 94-229, 94th Cong. 1st Sess., 111 (1975). But see Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2332, 2352-53 (1987) (Blackmun, J., dissenting) (language, legislative history, and purposes of Exchange Act mandate exception from FAA in same way Securities Act excepted).

"Id. at 2359 (Stevens, J., concurring in part and dissenting in part) (strong judicial
interpretation ought to originate in the legislature, rather than the judiciary.\(^7^0\)

The leading dissent, written by Justice Blackmun, attacked the Court’s opinion on all points.\(^7^1\) Reviewing securities arbitration cases as well as legislative history, Justice Blackmun observed that *McMahon* “effectively overrules *Wilko* . . .”\(^7^2\) The Justice found two fundamental problems with the majority opinion: first that it gave *Wilko* an overly narrow reading and second, that it accepted unconditionally the SEC’s newly adopted position that its oversight and procedures have so improved as to ensure the adequacy of arbitration.\(^7^3\) Justice Blackmun concluded that abuses in the securities industry are not adequately vindicated in arbitration and expressed hope that Congress would “give investors the relief that the Court denie[d] them . . .”\(^7^4\)

Since the *McMahon* decision upholding predispute arbitration for Exchange Act claims and the October, 1987 stock market crash, many customers who would otherwise be in court are now relegated to arbitral forums.\(^7^5\) In an effort to avoid *McMahon*’s reach, investors in the past eighteen months now charge violations of the Securities Act so that they will fall under the protection of *Wilko* which allows judicial resolution of claims notwithstanding the presence of a predispute arbitration presumption that *Wilko* applies to Exchange Act claims best rebutted by legislative rather than judicial branch).

\(^7^0\) Id.

\(^7^1\) Id. at 2346-59. See *supra* notes 60-68 and accompanying text (discussing *McMahon* holding and rationale).


\(^7^4\) Id. at 2358-59.

\(^7^5\) See letter, *supra* note 7, at 2 (96% of margin and options accounts subject to predispute arbitration clauses which raises serious policy issues); The Boston Globe, Dec. 20, 1988, at 57 col. 2 & 59, col. 1 (wave of arbitration filings following *McMahon* and 1987 stock crash); cf. letter from James E. Buck to David S. Ruder app. 2 (Oct. 14, 1988) (notwithstanding arbitration’s benefits, NYSE recognized process can be improved); letter from Richard G. Ketchum to James E. Buck (Sept. 10, 1987) (“need for change in SRO arbitration derives directly from the limits inherent in the current arbitration rules”).
agreements.  
Inevitably, a challenge to the thirty-six year old Wilko decision has reached the Court in the case of Rodriguez De Quijas v. Shearson/Lehman Brothers, Inc.  
On November 14, 1988, the Court granted certiorari to reconsider Wilko and to resolve the enforceability of predispute arbitration agreements as applied to the Securities Act.  
The customers were from Brownsville, Texas, including the Rodriguez De Quijas family and others who suffered financial losses, while the firm generated commissions for itself.  
The customers pleaded violations of state and federal securities laws.  
As per the standardized predispute arbitration clause, Shearson moved to stay litigation and compel arbitration of their claims.  
The district court concluded that Wilko controlled the disposition of Securities Act claims and exempted these from arbitration.  
The Court of Appeals reversed, concluding that McMahon "completely undermined Wilko" such that all federal securities claims are now subject to valid predispute arbitration agreements.  

79 845 F.2d 1296, 1297 (5th Cir. 1988) (court considered whether claims brought under § 12(2) of Securities Act subject to predispute arbitration agreements).  
80 Rodriguez De Quijas v. Shearson/Lehman Bros., Inc., 845 F.2d 1296 (5th Cir. 1988), cert, granted, 109 S. Ct. 389 (1988). See generally N.Y. Times, Nov. 15, 1988, § D1, col. 6, & D13, col. 1 (Court agreed to hear predispute arbitration agreement challenge to § 12(2); Wall St. J., Nov. 15, 1988, § B12, col. 2 (Court granted certiorari to decide whether disputes between brokers and purchasers alleging fraud must be resolved by arbitration).  
81 See Rodriguez De Quijas v. Shearson/Lehman Bros., Inc., 845 F.2d 1296, 1297 (5th Cir. 1988); see also Wall St. J., Nov. 15, 1988, § B12, col. 2 (Shearson generated commissions while causing losses for customers).  
83 Id. at 1297 & n.2.  
84 Id. at 1297. The appeals court noted that the district court correctly followed Wilko which barred arbitration of § 12(2) claims. Id.  
85 Id. at 1297-99 (emphasis added). The Court so held despite the fact that the McMahon Court did not address the issue of arbitrability of § 12(2) claims. Id. at 1298 & n.4.; see also Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2332, 2341 (1987); Di Fiore, supra note 7, at 270 (virtually all brokerage firms will now require customers to agree to predispute arbitration clauses). Compare Chang v. Lin, 824 F.2d 219, 222 (2d Cir. 1987)
will decide if anything remains of *Wilko*, and thereby resolve the split among the lower courts.\(^8^4\)

V. DISTINCTIONS BETWEEN THE SECURITIES ACT AND THE EXCHANGE ACT: WHETHER THEY MAKE A DIFFERENCE

If *Wilko* is to remain the law through a pronouncement in the *Rodrigues De Quijas* case, a critical distinction must be formed in order to set it apart from *McMahon*. Courts and commentators have compared and contrasted the provisions of each Act in an attempt to distinguish decisions under them.

First mentioned typically are the nonwaiver provisions.\(^8^5\) While some courts have reached for the conclusion that the nonwaiver provisions of the two Acts differ, the *McMahon* Court, however, stated that they were virtually identical.\(^8^6\) The corollary therefore is that provisions which may not be waived under one Act, may not be waived under the other Act (so *Wilko* must fall).

Second, the provision being waived in the broker-customer cases is usually the jurisdictional one providing courts with competence to hear securities disputes.\(^8^7\) Jurisdictional provisions of the two Acts differ


\(^8^6\) 107 S. Ct. 2332, 2338 (1987). The Court first found that the nonwaiver provision forbids only waiver of substantive obligations under the Exchange Act, and then concluded that *Wilko* did not compel a different result. *Id.*

somewhat. Under the Securities Act, a defrauded purchaser may sue in federal or state court. However, under the Exchange Act, a defrauded investor may sue only in federal court, which has led some to argue that a waiver of the jurisdictional provision in the former Act poses greater consequences.

A third distinction raised is the implied/express right of action difference. Some have argued that no Securities Act provision may be waived since it expressly provides for a private remedy, while the private remedy under the Exchange Act is merely implied. The McMahon Court declined to mention this distinction, so it is fair to say that this controversy is closed.

A fourth argument made is that Congress, in its 1975 amendments to the Exchange Act, intended to leave existing law alone (i.e., Wilko) as well as the generally accepted view then that Wilko applied to Exchange Act violations. This is probably the most troubling point since it is not plausible that Congress would disallow arbitration of Securities Act claims and then leave for courts to decide the same question as to Exchange Act claims. Interpretations of the legislative history are so diverse such that arguments based on the 1975 amendments are not dispositive.

88 See supra note 87 and accompanying text (discussing jurisdiction of Securities Act).
89 See supra note 87 and accompanying text (discussing jurisdiction of Exchange Act).
91 See Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2332, 2347 & n.n. 1, 2 (1987) (Blackmun, J., dissenting) (majority fails to even acknowledge express/implied right of action distinction); Malcolm & Segall, The Arbitrability of Claims Arising Under Section 10(b) of the Securities Exchange Act: Should Wilko Be Extended?, 50 ALB. L. REV. 725, 750 (1986) (difference between the two Acts' rights of action may not be as significant as courts have historically made it).
92 In 1975, Congress amended the Exchange Act at which time the Conference Report stated that "[i]t was the clear understanding of the conferees that... amendment[s] did not change the existing law, as articulated in Wilko v. Swan..." H.R. Rep. No. 94-229, 94th Cong., 1st Sess., 111 (1975). See Malcolm & Segall supra note 91, at 755 (during many years following Wilko, all eight circuits addressing issue held Wilko governed Exchange Act violations).
93 Compare Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2332, 2342-43 (1987) (Court unsure of Conference members' intentions) and Rodriguez De Quijas v. Shearson/Lehman Bros., Inc. 845 F.2d 1296, 1299 (5th Cir. 1988) (implausible that Congress intended to address only Securities Act claims) with Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2332, 2348 (1987) (Blackmun, J., dissenting) (legislative history on its face shows Congress intended to leave Wilko intact) and Ayres v. Merrill Lynch, Pierce,
Finally, the most crucial distinction between Wilko and McMahon is probably the quality of arbitration. While the other arguments may amount to fine distinctions, this point marks the difference between the two cases. Although there are questions with the McMahon opinion, two points are certain. It shows the Court’s enthusiasm for arbitration, and that Wilko’s mistrust of arbitration is difficult to reconcile with later decisions. Investors must, therefore, ready themselves for arbitration of their securities disputes.

VI. THE PRESENT STATE OF SECURITIES ARBITRATION

The history of securities (and other) arbitration cases since Wilko makes that decision appear to be an aberration and indicates an uncontroversible trend in favor of arbitration. This is so despite the fact that Congress specifically passed the Securities and Exchange Acts to protect investors and provide them with judicial remedies for securities violations.

Finding little difference between the Acts, and after a thorough review of McMahon, there is no doubt that the Court in deciding Rodriguez De Quijas will either formally overrule Wilko—or pare it down to such an extent as to render it devoid of meaningful precedential value.

If arbitration is to be the exclusive method of securities dispute resolution, the question becomes the degree to which these statutory rights may be vindicated in arbitration.

Supporters of arbitration point to AAA and SRO procedures as evidence that the system is precedentially fair to both customers and brokers. They further point out that arbitration offers privacy, and costs are lower, while speed is greater. These latter two praises, however,


94 107 S. Ct. 2332, 2341. The Court also noted that stare decisis concerns might counsel against upsetting Wilko. Id.

95 See generally Gugliotta v. Evans & Co., Inc., 690 F. Supp. 144 (E.D.N.Y. 1988) (courts more willing to uphold arbitration clauses since SEC has expansive power to ensure adequacy of procedures employed by exchanges and associations); Note, supra note 17, at 223 (investors have choice of arbitration organizations—some of which are unconnected to securities industry). But see Comment, Who’s Protecting the Investors? Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2332 (1987) Compels Private Claims Under § 10(b) of the Securities Exchange Act into Arbitration, 19 ARIZ. L.J. 793, 818 (1987) (if SEC devises arbitration rules responsive to policy concerns only then should Wilko fall).

96 See, e.g., B. Goldberg, E. Green, F. Sander, Dispute Resolution 189-90 (1985); Nelson, Section 10(b) and Rule 10b-5 Federal Securities Law Claims: The Need for the Uniform Disposition of the Arbitration Issue, 24 SAN DIEGO L. REV. 199, 199 (1987) (arbitration alternative circumvents costs, delays of litigation); Note, The Enforceability of Predispute Arbitration
may be misleading. It would be more accurate to state that the parties in an arbitration proceeding, to a great degree, set the costs and the pace. In securities disputes, both parties could be fairly portrayed as relatively sophisticated with ready financial resources. Since the resources exist, the parties will probably obtain the services of a stenographer, pursue extensive discovery, and retain counsel, all of which militate against an inexpensive and speedy process.\(^97\)

Another benefit to the parties, which some view as unfair, is that arbitral decisions are final, except under very limited circumstances.\(^98\) Although there exists a Code of Ethics for arbitrators, the limited grounds for judicial review may impair the court's task in this complex area of law.\(^99\)

The principle objections to mandatory arbitration of securities disputes relate to the fairness of the predispute clause, and the arbitrators as well as the procedures used. Frequently mentioned is the criticism that brokerage agreements are essentially contracts of adhesion.\(^100\) Since

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Agreements Under 10(b) and 10b-5 Claims, 43 WASH & LEE L. REV. 923, 952-53 (1986) (arbitration speedier, less expensive than litigation).


\(^98\) The feature of finality highlights the importance of the FAA, and the arbitration process in general because without this feature parties could automatically appeal to district court for a trial de novo. In such a scenario, the arbitration proceeding would be left with a mere supposition of correctness. See McLaughlin, Resolving Disputes in the Financial Community: Alternatives to Litigation, 41 ARB. J. 16, 20 (1986) (broad rights of appeal present in litigation absent from arbitration). Four grounds for vacating arbitration awards are available under the FAA. See 9 U.S.C.A. § 10 West 1981 & Supp. 1988).

\(^99\) See R. COULSON, supra note 10, at 118-23 (Canons are horatory suggesting arbitrators disclose conflicts of interest, avoid improprieties, decide cases in fair manner, respect confidences and relationships of trust). Judicial review is still limited to the four grounds listed in § 10 of the FAA, and to the concept of “manifest disregard for the law.” See Wilko v. Swan, 346 U.S. 427, (1953); note 28, supra and accompanying text (discussing review of arbitral decisions).

\(^100\) This has been defined as a case where “…the contracting party with superior bargaining strength presents a standardized form agreement to a party with lesser bargaining power and requires the party to accept or reject the terms without an opportunity to negotiate.” Sanchez, Should Claims Involving Public Customers Arising Under the Securities Exchange Act of 1934 Be Subject to Compulsory Arbitration? 10 HARV. J.L. & PUB. POLICY, 173, 185 (1987). Courts may enforce such contracts since they might add to enterprise efficiency and stability. Contracts of adhesion will not be enforced under two circumstances. See DiFiore, supra note 7, at 269 (Court will not enforce adhesion contract if not within weaker party's reasonable expectations or if terms unduly oppressive, unconscionable). Compare Woodyard v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 640 F. Supp. 760 (S.D. Tex. 1986) (court refused to enforce arbitration provision against unsuspecting customer) with Surnian v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 733 F.2d 58 (8th Cir. 1984) (arbitration clause enforceable despite its standardized form and inequality in parties’
arbitration is almost the exclusive method of securities dispute resolution, this limits investors’ choices even further. This necessitates even closer scrutiny of the contracts to determine whether they are enforceable. The Court in Mitsubishi Motors cautioned judges to be “attuned to . . . claims that the agreement . . . resulted from the sort of fraud or overwhelming economic power that would provide grounds . . .” for revocation. Courts must scrutinize the fairness of the parties’ agreement, especially when customers have no choice but to sign it to invest, and when brokers represent large institutional entities.

Further criticisms have been leveled at the decision making and award process. Arbitrators are not bound by judicial precedent, so that predictability of outcomes is undercut. Nor must arbitrators file written opinions, which drastically undercut the effectiveness of judicial review. As a corollary to this point, arbitral decisions offer no guidance for future disputes. On the other hand, this feature serves to reduce formality and costs and to substantiate the role of the FAA. The author speculates that this leads to a lack of consistency and predictability in outcomes, and encourages questions into the system’s fairness. Securities disputes

bargaining strength).

101 See DiFiore, supra note 7, at 270 (virtually all brokerage houses require customers to sign arbitration agreement prior to investing); see letter, supra note 7 and accompanying text (discussing typical customer agreement). James E. Buck of the New York Stock Exchange responded to SEC Chairman Ruder’s letter, commenting on Chairman Ruder’s Congressional testimony. See letter from James E. Buck to David S. Ruder (Oct. 14, 1988), at 6-8 [hereinafter Buck’s letter] (SEC believes customers should have sufficient notice of their arbitration clause, and SRO’s should prevent brokers from using economic power to limit customers’ rights).

102 473 U.S. 614, 627 (1985). See generally Buck’s letter, supra note 101 at 8 (Chairman Ruder suggests that not all securities cases appropriate for arbitration such as those involving class actions, difficult complex cases, and those involving novel legal theories and challenges to industry practice).


104 While arbitrators’ awards are written, their opinions are not, so that courts are left with a very meager record upon which to base their review. See Lipton, supra note 25, at 13-14 (arbitration awards typically made without explanation for award or of principles of law that have been applied); note 25, supra and accompanying text. But see Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2382, 2340 (1987) (although judicial scrutiny limited, review sufficient to ensure arbitrators comply with statutory requirements).

105 See letter from the Securities Industry Conference on Arbitration to Richard G. Ketchum (Dec. 14, 1987) at 6-7 (SICA agrees with SEC recommendation for maintenance of case results, but then criticizes plan as lacking in utility and misleading in nature).
are frequently complex matters, for which findings of fact and conclusions of law would appear to be indispensable.

Further, arbitrators’ awards are currently limited to compensatory damages, and thereby tend to favor the securities industry.¹⁰⁶ This, however, appears to be changing so that punitive damages are more frequently awarded, and thus arbitration awards are approaching the remedy available in court.¹⁰⁷

Supporters of arbitration clauses point to their success in the labor context as evidence of their efficacy. Securities disputes are more transactional than relational in nature, so that there is less reason to promote the parties’ relationship in the securities context than in the labor context. Finally, whereas the parties in the labor scenario bargained for their agreement, such bargained for exchange is entirely absent in the securities arena.¹⁰⁸

Finally, critics argue that the arbitration system is “loaded” in favor of the securities industry and that most arbitrators have “significant ties” to it.¹⁰⁹ Although evidence exists to support these claims, recent studies tend to show that customers prevail more often than not.¹¹⁰ It appears

¹⁰⁷ Robbins, supra note 106, at 13 (trend towards allowing primitive damages as more varied claims made in arbitration proceedings).
¹⁰⁸ See supra notes 100-101 and accompanying text (discussing involuntariness of securities arbitration agreements).
¹⁰⁹ See Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2332, 2355 (1987) (Blackmun, J., dissenting) (possible for arbitrators to have clients who have been exchange members or SRO’s); N.Y. Times, Mar. 29, 1987, § C8, col. 1 (securities arbitration expert observed that brokerage houses like present system because they own the stacked deck). Arbitrators with significant ties to the industry have been defined as “Persons who have been directly or indirectly within the last five years employed by or acted as counselors, consultants, to any SRO or affiliate.” Friedman, supra, note 16, at 29. For a discussion of SICA’s recommendations on categories of persons who should be excluded from serving as arbitrators, see letter, supra note 105, at 2-3.
¹¹⁰ See Bedell, Harrison, & Harvey, supra note 17, at 9 & n. 57 (1985 AAA survey results showed 68% success rate for customers along with four punitive awards); SICA Rep’t. No. 5, at 6 (April 1986) (NASD statistics revealed awards to 55% of customers). But cf. Shearson/American Express, Inc. v. McMahon, 107, S. Ct. 2332, 2356 & n. 20 (1987) (Blackmun, J., dissenting) (arbitration results do not indicate amount received so that customers could prevail but then recover amounts less than actual damages). In response to the SEC’s request for more information on predispute arbitration agreements, the NYSE commissioned Deloitte Haskins & Sells to audit customer originated cases. See letter, supra note 101, at 4-7 & Exhibit A. The results tend to show that arbitration was a few months’ speedier than litigation; legal costs were lower for arbitration; and payments to customers were four times higher for arbitrated claims than for litigated claims. Letter, supra note 101,
overall, that the securities industry is comfortable with the present system and does not welcome proposed changes to it.¹¹¹

The SEC is the regulating authority charged by Congress with the task of reconciling conflicts inherent in the arbitration of securities disputes. Its role in the regulation and enforcement of securities laws through arbitration has been questionable. Indeed, until McMahon, the SEC consistently considered it to be a fraudulent, manipulative, or deceptive act for brokers to bind customers to predispute arbitration agreements.¹¹² (Possibly anticipating McMahon, the SEC filed a brief as Amicus Curiae contending that its former position was based solely upon Wilko rather than upon an independent analysis.) Since McMahon, the SEC has attempted to overcome its ambivalence towards arbitration by instituting many positive changes in arbitration procedures.¹¹³ SEC Chairperson Ruder's position is one of support for arbitration, but also tempers this by acknowledging that despite Supreme Court pronouncements, not every securities dispute is appropriate for arbitration.

The author observes at this point, that with so many changes in arbitration, the McMahon Court's support for arbitration appears in hindsight to have been somewhat overdone. Controls on conflict of interest

at 5 & Exhibit A. Furthermore, customers received a greater percentage of their claim in arbitration than in litigation. Letter supra note 101, at 5 & Exhibit A. In absolute dollars customers received about $25,000 in litigation, and about $35,000 in arbitration while firms reported that arbitration costs were lower than litigation costs. Letter, supra note 101, at 6 & Exhibit A.

¹¹¹ See Shearson/American Express, Inc. v. McMahon, 107 S. Ct. 2332, 2355 (1987) (Blackmun, J., dissenting) (overwhelming support by securities industry for compelled arbitration suggests some truth to belief that industry has advantage) (emphasis in original); see also letter from Joseph R. Hardiman to David S. Ruder (Oct. 14, 1988) at 1-2 (NASD argued prohibition of arbitration clauses would lead to increased commission rates, or reduction in services, and suggested their insurance rates would be adversely impacted); letter from John M. Liftin to Richard A. Grasso (Oct. 6, 1988) (Kidder Peabody alleged that customer initialling of arbitration clauses to signal awareness and agreement too costly and time consuming and would foster litigation); letter from Joel E. Davidson to John J. Phelan, Jr. (Oct. 5, 1988) (Paine Webber generally "supports" SICA's proposed rules changes with exception of initialling requirement because it would be too burdensome and may dissuade customer from reviewing rest of agreement); letter from Jeffrey B. Lane to John T. Phelan, Jr. (Oct. 4, 1988) (Shearson Lehman Hutton also opposes initialling requirement because it places undue emphasis on arbitration clause and encourages needless litigation).

¹¹² See supra notes 48 & 67 and accompanying text (discussing former SEC position).

and arbitrator training cannot be overemphasized to remedy defects in the arbitration process. Congress ought to consider an expansion of judicial review for arbitral decisions. Discovery should be the rule rather than the exception in arbitration proceedings. Finally, customers must be able to make an informed and meaningful choice on whether to agree to a predispute arbitration clause. Compelling arbitration due to a clause signed as a precondition to investing without negotiation unfairly curtails Congressionally created, and judicially recognized rights.

VII. CONCLUSIONS

The solution appears to lie in increased Congressional and SEC oversight if investors' rights are to be properly vindicated without the assistance of the courts. Arbitration is, however, a very attractive dispute resolution technique in cases where both sides knowingly agree to be bound by it. It seems that if arbitration is to be the exclusive dispute resolution method, that Congress and the SEC bear a heavy responsibility to ensure that customer's rights are adequately protected.

114 It may be that customers fare just as well, if not better, in arbitration. But public perception of market fairness is crucial to confidence and stability in the capital markets. For courts and Congress to allow private remedies under the Securities and Exchange Acts, and then to permit brokerage firms to unilaterally impose arbitration upon customers seems to undermine the system's fairness.