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Enforcement of Pre-Dispute Arbitration Clauses in Broker-Investor Contracts: Are Investors Protected?

On Monday October 19, 1987, now known as "black Monday," the Dow Jones Industrial Average tumbled 508 points and the market lost over 20 percent of its value.¹ Not since the stock market crash of the great depression² have investors lost such huge sums of money.³ Yet, money is made and lost every day on Wall Street. When money is made, investors congratulate themselves on their astute business decisions. When money is lost, however, investors look for someone to blame. Many times the blame, justly or unjustly, falls on the broker that purchased the slumping securities.

In order to avoid potential litigation, brokerage houses include arbitration clauses in their form contracts signed by investors.⁴ Although arbitration clauses have long been standard in broker/investor contracts, their enforceability has long been in question.

Congress, favoring the use of arbitration, passed the United States Arbitration Act⁵ which makes pre-dispute arbitration clauses specifically enforceable.⁶ Yet, at one time, the Arbitration Act did not apply to causes of action brought under the Securities Act of 1933⁷ or the Secur-

1. Wall St. J., Oct. 20, 1987, at 1, col. 2.

The Stock Market Crashed as panic selling swept the Dow Jones industriales down 508.00 points or 22.6%, to 1738.74. The record decline far exceeded the drop on Oct. 28, 1929, when the average slid 12.8%. Most other market indicators also skidded to record lows, as Big Board volume soared to 604.3 million shares, well above the previous record.

Id.

2. "On Oct. 28, 1929, the stock market fell 12.8%, ushering in the Great Depression." *Id.* at 1, col. 5.

3. It has been estimated that investors lost about \$500 billion on October 19, 1987. *Id.*

"When the stock market drops by \$1 trillion—which is roughly how far all the stocks on the New York Stock Exchange have fallen in less than two months—that plunge is enough to wipe out decades of savings." N.Y. Times, Oct. 21, 1987, at 1, col. 3.

4. A typical arbitration clause states:

Any controversy between you and the undersigned arising out of or relating to this contract or the breach thereof, shall be settled by arbitration, in accordance with the rules, then obtaining, of either the Arbitration Committee of the Chamber of Commerce of the state of New York, or the American Arbitration Association, or the Board of Arbitration of the New York Stock Exchange, as the undersigned may elect.

Comment, *Arbitration of Investor-Broker Disputes*, 65 CALIF. L. REV. 120, 125 (1977) (quoting 8 C. NICHOLS, CYCLOPEDIA OF LEGAL FORMS ANNOTATED § 8.1710, at 921 (1973)).

5. 9 U.S.C. §§ 1-14 (1982) [hereinafter Arbitration Act].

6. 9 U.S.C. § 2 (1982) (limited to contracts in interstate commerce; effectively any contract).

7. 15 U.S.C. §§ 77a-77aa (1982) [hereinafter Securities Act].

ities Exchange Act of 1934.⁸ The Supreme Court's decision in *Shearson/American Express, Inc. v. McMahon*,⁹ however, now makes it clear that if a broker/investor contract contains a governing pre-dispute arbitration clause, all disputes arising under the Securities Act or the Exchange Act must be resolved through binding arbitration.¹⁰

Impelled by the stock market crash in October and the Supreme Court Ruling in *McMahon*, "thousands of investors are filing for arbitration"¹¹ to resolve differences between themselves and their brokers. Because of this sudden increase in the use of arbitration as an alternative to litigation, guidance in this area is needed now more than ever. The purpose of this article is to examine the real and perceived problems now present in the securities arbitration system and suggest ways to improve the system. This article concludes by evaluating recommendations made by the Securities Exchange Commission that are designed to ensure the protection of investors.

I. BACKGROUND

A. Statutory Law

Historically, courts viewed arbitration to be an inferior method of settling disputes.¹² Congress, however, believing that arbitration was a viable means of settling disputes between parties, passed the Arbitration Act¹³ which instituted a "liberal federal policy favoring arbitration agreements."¹⁴

The Arbitration Act provides that arbitration clauses "shall be

8. 15 U.S.C. §§ 78a-78kk (1982) [hereinafter Exchange Act].

The Supreme Court in *Wilko v. Swan*, 346 U.S. 427 (1953), held that a claim brought under section 12(2) of the Securities Act of 1933 was not subject to a pre-dispute arbitration clause contained in a contract signed by the parties. After *Wilko*, courts consistently held agreements to arbitrate disputes under both the Securities Act and the Exchange Act equally invalid. T. HAZEN, *THE LAW OF SECURITIES REGULATION* § 14.4, at 531 (1985).

9. 107 S. Ct. 2332 (1987).

10. Although the Supreme Court in *McMahon* did not overrule *Wilko*, it appears that if the issue in *Wilko* were brought before the Court today, *Wilko* would be overruled. See *infra* notes 49 and 50.

11. Salwen, *Investors Swamp Securities-Arbitration System*, Wall St. J., Mar. 15, 1988, at 39, col. 3:

The New York Stock Exchange estimates that since October about 120 cases have been filed every month—a 60% increase from year-earlier levels. The National Association of Securities Dealers says that 1987 cases grew 82% over the 1986 level and that this year's pace is running an annualized 45% higher.

12. Scherk v. Alberto-Culver Co., 417 U.S. 506, 510 (1974) (This hostility began with the English courts and was adopted by the American courts). Fletcher, *Privatizing Securities Disputes Through The Enforcement of Arbitration Agreements*, 71 MINN. L. REV. 393 (1987).

13. 9 U.S.C. §§ 1-14 (1982).

14. *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983).

valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."¹⁵ The Act goes on to provide that courts "shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement"¹⁶ Moreover, courts are required to issue orders compelling arbitration when a valid agreement is found.¹⁷

"The Arbitration Act . . . was designed to allow parties to avoid 'the costliness and delays of litigation,' and to place arbitration agreements 'upon the same footing as other contracts'"¹⁸ While pre-dispute arbitration agreements at one time were revokable at will,¹⁹ the Arbitration Act creates a presumption favoring arbitration agreements, and "doubts about the scope of arbitration [are to be] resolved in favor of arbitration."²⁰

Conflicts, however, may arise between the Arbitration Act and other congressional acts. An example of this conflict arises when a court is faced with a choice between enforcing an arbitration clause under the Arbitration Act and enforcing the judicial forum requirement granted under the Securities Act²¹ and the Exchange Act.²² Both Acts give courts exclusive jurisdiction over claims brought under each Act.²³ Both Acts also prohibit the waiver of compliance with any of the Acts' provisions,²⁴ including the waiver of the judicial forum requirement. A pre-dispute arbitration agreement is arguably a waiver of the judicial forum

15. 9 U.S.C. § 2 (1982).

16. 9 U.S.C. § 3 (1982).

17. 9 U.S.C. § 4 (1982).

18. *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 511 (1944) (quoting H.R. REP. NO. 96, 68th Cong., 1st Sess., 1, 2 (1924)).

19. Comment, *Arbitrability of Implied Rights of Action Under Section 10(b) of the Securities Exchange Act*, 61 N.Y.U. L. REV. 506, 510 (1986) (and sources cited therein).

20. *Moses H. Cone*, 460 U.S. at 24.

21. 15 U.S.C. § 77v(a) (1982).

22. 15 U.S.C. § 78aa (1982); *Wilko v. Swann*, 346 U.S. 427, 438 (1957); *Katsoris, Arbitration of a Public Securities Dispute*, 53 *FORDHAM L. REV.* 279, 294 (1984).

23. Section 27 of the Exchange Act confers jurisdiction of violations of the Exchange Act on the district courts of the United States.

The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter of the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder.

15 U.S.C. § 78aa (1982). Section 22 of the Securities Act, 15 U.S.C. § 77v(a) (1982), contains a similar provision.

24. Section 29(a) of the Exchange Act, 15 U.S.C. § 78cc (1982), voids "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of [the Exchange Act] or of any rule or regulation thereunder, or any rule of an exchange required thereby . . ." Section 14 of the Securities Act, 15 U.S.C. § 77n (1982), contains similar language.

requirement under the Securities Act and the Exchange Act. If this is so, the anti-waiver provisions of the Securities Act and the Exchange Act, would be in direct conflict with the Arbitration Act which mandates enforcement of pre-dispute arbitration clauses. The following section traces the history of the Supreme Court's resolution of this conflict.

B. *Judicial History: From Wilko to McMahon*

The Supreme Court's view, as to whether pre-dispute arbitration clauses between securities brokers and investors are enforceable has changed completely, from holding that arbitration clauses were unenforceable in *Wilko*²⁵ to virtually overruling *Wilko* and declaring arbitration clauses enforceable in *McMahon*.²⁶

*Wilko*²⁷ dealt with a dispute between a brokerage firm and an investor. The Court, faced with the apparent conflict between the Arbitration Act and the Securities Act, had to decide whether claims brought under section 12(2) of the Securities Act²⁸ should be subject to compulsory arbitration. The brokerage firm sought to enforce the pre-dispute arbitration agreement by moving to have the trial stayed under section 3 of the Arbitration Act.²⁹ The Supreme Court ruled against the brokerage firm's motion noting that section 22(a) of the Securities Act³⁰ gave the federal courts jurisdiction over claims brought under the Securities Act.³¹ In addition, the Court noted that section 14 of the Securities Act³² prohibited the waiver of any section of the Securities Act.³³ The Court held that the arbitration clause contained in the contract was an attempt to waive the choice of forums provided under section 22(a) of the Securities Act,³⁴ and was therefore void.³⁵

In *Wilko*, the Court expressed its displeasure with arbitration in general, listing several ways in which arbitration was inferior to judicial proceedings.³⁶ Since *Wilko* the Court's view of arbitration has

25. *Wilko*, 346 U.S. at 438.

26. See *infra* notes 49 and 50 and accompanying text.

27. 346 U.S. 427 (1953).

28. "Any person who offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of material fact or omits to state a material fact . . . shall be liable to the person purchasing such security from him . . ." 15 U.S.C. § 77i (1982).

29. 9 U.S.C. § 3 (1982).

30. 15 U.S.C. § 77v(a) (1982).

31. *Wilko*, 346 U.S. at 433.

32. 15 U.S.C. § 77n (1982).

33. *Wilko*, 346 U.S. at 430.

34. 15 U.S.C. § 77v(a) (1982).

35. "[T]he right to select the judicial forum is the kind of 'provision' that cannot be waived under § 14 of the Securities Act." *Wilko*, 346 U.S. at 434-35.

36. *Wilko*, 346 U.S. at 435-36 (lack of judicial review, arbitrators' lack of judicial training,

evolved to the point of accepting arbitration as a favorable means of dispute resolution. The Supreme Court's decision in *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*³⁷ marked a pronounced change in the Court's view of arbitration from being an inadequate form of dispute resolution,³⁸ to adopting a liberal policy favoring arbitration agreements³⁹ and finding arbitration completely desirable.⁴⁰

Although *Moses H. Cone* did not involve a securities claim, it did rule on the enforceability of a pre-dispute arbitration clause contained in a construction contract signed by the parties. The Court held the Arbitration Act established, "as a matter of federal law," that "any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability."⁴¹

The Court's new-found acceptance of arbitration led to other decisions that consistently favored arbitration as a valid means of dispute resolution.⁴² Nevertheless, *Wilko* had not been overruled, and therefore,

arbitration not suited for subjective findings that must be made).

37. 460 U.S. 1 (1983).

38. *Wilko*, 346 U.S. at 435.

39. *Moses H. Cone*, 460 U.S. at 24.

40. *Id.*

41. *Id.*

42. The Court began to modify *Wilko* in *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974). The dispute in *Scherk* arose out of the alleged breach of a sales contract. The contract signed by the parties contained an agreement to arbitrate any future disputes between the parties before the International Chamber of Commerce in Paris, France. After allegedly discovering that trademarks purported to have been unencumbered by Scherk were in fact substantially encumbered, Alberto-Culver brought suit claiming violations of Rule 10b-5 promulgated under § 10(b) of the Exchange Act. On appeal, the Supreme Court distinguished the case from *Wilko* on the grounds that the "contract to purchase the business entities belonging to Scherk was a truly international agreement" which "involve[d] considerations and policies significantly different from those found controlling in *Wilko*." 417 U.S. at 515.

Although the Court in *Scherk* upheld a pre-dispute arbitration clause in a dispute involving a Rule 10b-5 claim, the Court failed to explicitly hold that *Wilko* did not apply to all Rule 10b-5 causes of action. The Court's holding appeared to create only a small "international" exception to the *Wilko* doctrine. *Mansbach v. Prescorr, Ball & Turben*, 598 F.2d 1017, 1030 (6th Cir. 1979) (*Scherk* is a "narrow exception to *Wilko* for cases concerning international securities transactions"); *Newman v. Shearson, Hammill & Co. Inc., v. Moore*, 590 F. Supp. 265, 268 (W.D. Tex. 1974) (*Scherk* is a "narrow exception to the *Wilko* holding, and is applicable only to international transactions.").

In *Southland Corp. v. Keating*, 465 U.S. 1 (1984) the Court held that the Arbitration Act preempts any state statute with which it is in conflict. The Court stated that "Congress declared a national policy favoring arbitration and withdrew the power of the states to require a judicial forum for the resolution of claims that the contracting parties agreed to resolve by arbitration." 465 U.S. at 10.

In *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213 (1985) the Court held that the "Arbitration Act requires district courts to compel arbitration of pendent arbitrable claims when one of the parties files a motion to compel, even when the result would be the possibly inefficient mainte-

seemed to govern many causes of action brought under the Securities Act or the Exchange Act. The recent decision in *McMahon*, however, makes it clear that pre-dispute arbitration clauses do apply to disputes involving securities claims in spite of the holding in *Wilko*.⁴³

The issue in *McMahon* was whether a claim brought under Rule 10b-5 (promulgated under section 10(b) of the Exchange Act)⁴⁴ was subject to the pre-dispute arbitration clauses contained in two broker/investor agreements.⁴⁵ In the complaint, the McMahons alleged that Shearson, through one of its brokers, had violated Rule 10b-5⁴⁶ by "engaging in fraudulent, excessive trading on respondents' accounts and by making false statements and omitting material facts from the advice given to respondents."⁴⁷ Once again, the Supreme Court faced a conflict between the Arbitration Act and the Exchange Act. The Court stayed the trial pending the outcome of arbitration. The Court examined the *Wilko* holding and concluded that "*Wilko* must be understood . . . as holding that the plaintiff's waiver of the 'right to select the judicial forum,' was unenforceable only because arbitration was judged inadequate to enforce the statutory rights created by section 12(2) [of the Securities Act of 1933]."⁴⁸

Although the Court did not explicitly overrule *Wilko*, the opinion has effectively been gutted and has, practically speaking, been over-

nance of separate proceedings in different forums." 470 U.S. at 217.

In *Mitsubishi Motors v. Soler Chrysler-Plymouth*, 473 U.S. 614 (1985) the Court held that an "American court should enforce an agreement to resolve antitrust claims by arbitration when that agreement arises from an international transaction." 473 U.S. at 624.

43. See *infra* notes 49 and 50 and accompanying text.

44. Rule 10b-5 states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course or business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1986).

45. *McMahon*, 107 S.Ct. at 2335. The Court also addressed a second issue of whether a claim brought under the Racketeer Influenced and Corrupt Organizations Act (RICO), was also subject to the arbitration agreement. Because the RICO claim is beyond the scope of this article it will not be considered. It was, however, found that the RICO claim was subject to the arbitration agreement. *Id.* at 2346.

46. 17 C.F.R. § 240.10b-5 (1986).

47. *McMahon*, 107 S. Ct. at 2336.

48. *McMahon*, 107 S. Ct. at 2338.

ruled.⁴⁹ Since the Court declined to explicitly overrule *Wilko*, it could be argued that claims brought under section 12(2) of the Securities Act are not subject to pre-dispute arbitration agreements. The language of the Court in *McMahon*, however, appears to indicate that claims under section 12(2) will be subject to arbitration in the future.⁵⁰ By overruling the Court's rationale in *Wilko*, *McMahon* has left nothing of substance in the *Wilko* opinion. If decided today, *Wilko* would likely be decided in favor of arbitration.

II. PROBLEMS WITH ARBITRATION IN THE SECURITIES INDUSTRY

Prior to *McMahon*, pre-dispute arbitration clauses were thought to be unenforceable. Investors could bring securities claims in federal court regardless of the existence of an arbitration clause.⁵¹ With the enforcement of arbitration clauses in *McMahon*, however, the use of arbitration has increased. Consequently, much more stress and responsibility is being placed on the securities arbitration system.⁵² Because arbitration is fast becoming the only resort investors have against securities violations by broker-dealers, the SEC must reevaluate the arbitration system to determine whether it ensures investor protection consistent with the purpose of the Securities Act and the Exchange Act.⁵³

49. "[T]he Court effectively overrules *Wilko* by accepting . . . the position that arbitration procedures in the securities industry and the Commission's oversight of the self-regulatory organizations (SROs) have improved greatly since *Wilko* was decided." *Id.* at 2346 (Blackmun, J., dissenting).

50. The Court did not get to the exact issue decided in *Wilko* and therefore refused to reverse the *Wilko* decision. However, the Court states:

[T]he mistrust of arbitration that formed the basis for the *Wilko* opinion in 1953 is difficult to square with the assessment of arbitration that has prevailed since that time. This is especially so in light of the intervening changes in the regulatory structure of the securities laws. Even if *Wilko's* assumptions regarding arbitration were valid at the time *Wilko* was decided, most certainly they do not hold true today for arbitration procedures subject to the SEC's oversight authority.

Id. at 2341.

51. See Securities Exchange Act Rel. No. 15948, (1979, Fed. Sec. L. Rep. (CCH) ¶ 82,122; Rule 15c2-2, 17 CFR § 240.15c2-2 (1986) (stating the SEC's belief that pre-dispute arbitration agreements were unenforceable).

52. Securities and Exchange Commission letter from Richard G. Ketchum, Director, to all members of the Securities Industry Conference on Arbitration (SICA), Sept. 10, 1987 at 1 (hereinafter SEC Letter) ("[R]ecent cases upholding predispute arbitration agreements together with increasing post-dispute selection of sponsored arbitration suggest that SRO-sponsored arbitration may become the primary forum for the resolution of disputes between broker-dealers and investors.").

"Spurred by last October's debacle and [the *McMahon* decision], thousands of investors are filing for arbitration—the investment industry's answer to the court system and most investors' sole form of recourse when they believe they have been wronged." Wall St. J., Mar. 15, 1988, at 39, col. 3.

53. "[T]he Securities Act of 1933 was [d]esigned to protect investors" and to require "issu-

Problems in the arbitration system both actual and perceived could inhibit the system's ability to protect investors.

A. *Substantive Problems With Arbitration*

1. *Arbitration clauses in adhesion contracts*

The arbitration of securities disputes is a proceeding where the parties involved contractually agree to submit their contentions to arbitrators selected by the parties.⁵⁴ One of the keys to fairness in arbitration is that the parties may freely bargain for the exact form of arbitration with which each party feels comfortable. When arbitration is forced on an unwilling party, however, the fairness gained from the free bargaining process is lost.

One way arbitration may be forced on a party is through the use of an adhesion contract. Adhesion contracts occur when one party having a distinct bargaining disadvantage must either accept or reject the terms of the contract without negotiation.⁵⁵ An issue of adhesion frequently arises in standardized contracts, such as those drawn up by brokerage houses for wide-spread use in customer agreements. Because the contract is offered on a take it or leave it basis, investors are unable

ers, underwriters, and dealers to make full and fair disclosure of the character of securities sold in interstate and foreign commerce and to prevent fraud in their sale,' by creating 'a special right to recover for misrepresentation . . .'" Scherk v. Alberto-Culver Co., 417 U.S. 506, 512 (quoting *Wilko*, 346 U.S. at 431); *McMahon*, 107 S. Ct. at 2346 (1987) (Blackmun, J., dissenting) ("Both the Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted to protect investors from predatory behavior of securities industry personnel."). See, e.g., Comment, *The Preclusive Effect of Arbitral Determinations in Subsequent Federal Securities Litigation*, 55 *FORDHAM L. REV.* 655, 668 n.1 (1987).

54. M. DOMKE, *DOMKE ON COMMERCIAL ARBITRATION* § 1:01 (rev. ed.) (quoting *Gates v. Arizona Brewing Co.*, 54 *Ariz.* 266, 269, 95 P.2d 49, 50 (1939)) ("[A]rbitration is a contractual proceeding, whereby the parties to any controversy or dispute . . . select judges of their own choice and by consent submit their controversy to such judges for determination, in the place of the tribunals provided by the ordinary processes of law.")

55. Standard contracts are typically used by enterprises with strong bargaining power.

The weaker party, in need of the goods or services, is frequently not in a position to shop around for better terms, either because the author of the standard contract has a monopoly (natural or artificial) or because all competitors use the same clauses. His contractual intention is but a subjection more or less voluntary to terms dictated by the stronger party, terms whose consequences are often understood only in a vague way, if at all. Thus, standardized contracts are frequently contracts of adhesion

Kessler, *Contracts of Adhesion—Some Thoughts about Freedom of Contract*, 43 *COLUM. L. REV.* 629, 632 (1943).

Adhesion contract is a handy shorthand descriptive of standard form printed contracts prepared by one party and submitted to the other on a 'take it or leave it' basis. The law has recognized there is often no true equality of bargaining power in such contracts and has accommodated that reality in construing them.

M. DOMKE, *DOMKE ON COMMERCIAL ARBITRATION* § 5:04 (rev. ed.) (quoting *Standard Oil of California v. Perkins*, 347 F.2d 379, 383 (9th Cir. 1965)).

to bargain for favorable arbitration rules. Thus, investors are bound to the arbitration rules dictated by the broker-dealer and the fairness gained from free bargaining is lost.

The inability of investors to negotiate for arbitration rules takes away an investor's ability to choose the most favorable method of dispute resolution. Because arbitration should be an optional procedure, not a mandatory one, an arbitration clause in an adhesion contract may be seen as a "theoretical inconsistency."⁵⁶ Arbitration should be a voluntary means of solving disputes.⁵⁷ It should not be coerced. "[A]dvocates of arbitration continue to stress that parties should agree to arbitrate conflicts arising between them on a wholly voluntary basis. . . . Yet, voluntariness and equality of bargaining power have no place in [adhesion] contracts"⁵⁸

As a matter of contract law, however, an adhesion contract is not always unenforceable.⁵⁹ In fact, standardized contracts are very important in business, eliminating duplicative work and enabling a more confident allocation of risks assumed by the parties.⁶⁰ Only two basic limitations on the enforceability of an adhesion contract exist. First, if a provision in an adhesion contract does not fall within the reasonable expectations of the non-drafting party, the provision will not be enforced against him.⁶¹ Because of the widespread use of arbitration clauses in securities contracts an investor would presumably have a reasonable expectation that such provisions would be included.⁶² Consequently, this limitation may not be applicable to an investor when he has a reasonable expectation that the clause would be provided. Second, even if the provision is within the reasonable expectation of the parties, it will not be enforced if it is oppressive or unconscionable.⁶³ A finding of oppression or unconscionability in a pre-dispute arbitration clause may be unlikely considering the Court's favorable view of arbitration. On the other hand, denial of access to the courts caused by an investor's

56. Wright, *Arbitration Clauses in Adhesion Contracts*, 33 *ARB. J.* 41, 41 (1978).

57. M. DOMKE, *DOMKE ON COMMERCIAL ARBITRATION* § 1:01 (Rev. Ed.) ("An arbitration can validly take place only if the parties have specifically and expressly agreed to use this method for the settlement of their disputes."); Goldberg, *A Supreme Court Judge Looks at Arbitration*, 20 *ARB. J.* 13, 16 (1965) ("Voluntary arbitration must be *voluntary* in a real and genuine sense.") (emphasis in original).

58. Wright, *Arbitration Clauses in Adhesion Contracts*, 33 *ARB. J.* 41, 41 (1978).

59. E. FARNSWORTH, *CONTRACTS* 295 (1982).

60. Kessler, *Contracts of Adhesion—Some thoughts about Freedom of Contract*, 43 *COLUM. L. REV.* 629, 631 (1943) (citing "standard clauses in insurance policies [as] the most striking illustrations of successful attempts on the part of business enterprises to select and control risks assumed under a contract").

61. Katsoris, *supra* note 22, at 279, 306.

62. *See id.* at 292 n.86.

63. Katsoris, *id.* at 307.

involuntary acceptance of an arbitration provision could be considered oppressive.⁶⁴

Additionally, it has been argued that contracts between brokers and investors are not adhesion contracts because not all brokerage houses require investors to sign contracts which include arbitration clauses.⁶⁵ If arbitration clauses are not included in all securities contracts, investors could seek brokerage houses that use contracts that do not contain arbitration clauses. If this were the case, agreeing to arbitration would not be a prerequisite to gaining access to the securities market. Therefore, arbitration would not be forced on investors.

On the other hand, it is not clear what percentage of brokerage houses require pre-dispute arbitration agreements. Most, if not all, brokerage houses at least include arbitration clauses in margin agreements and discretionary account agreements.⁶⁶ Other brokerage houses also include arbitration clauses in cash account agreements.⁶⁷ Furthermore, because of the recent decisions favoring arbitration,⁶⁸ and the advantage arbitration agreements give to brokers and investors,⁶⁹ the remaining brokerage houses will likely require arbitration agreements in the future. This means that the issue of adhesion, if not a present problem, may become a problem in the future.

2. *Problems with arbitrators*

There is a perception that arbitrators are biased in favor of broker-dealers due to the arbitrator's general connection with the securities industry.⁷⁰ "[B]ecause of the background of the arbitrators, the investor has the impression, frequently justified, that his claims are being judged by a forum composed of individuals sympathetic to the securities industry and not drawn from the public."⁷¹

In an attempt to ensure the impartiality of the arbitrators, the

64. *See id.*

65. *See Fletcher, supra* note 12, at 447.

66. *Id.*; Katsoris, *supra* note 22, at 292 n.86.

67. Fletcher, *supra* note 12, at 447.

68. *Shearson/American Express, Inc. v. McMahon*, 107 S. Ct. 2332 (1987); *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth Inc.*, 473 U.S. 614 (1985); *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213 (1985); *Southland Corp. v. Keating*, 465 U.S. 1 (1984); *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1 (1983); *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974).

69. F. ELKOURI, *HOW ARBITRATION WORKS* 7 (4th Ed. 1985)(cites the "saving of time, expense, and trouble" as advantages of arbitration over litigation).

70. *McMahon*, 107 S. Ct. at 2355 (Blackmun, J., dissenting). Fletcher, *supra* note 12, at 451.

71. *McMahon*, 107 S. Ct. at 2355 (Blackmun, J., dissenting).

Uniform Code of Arbitration⁷² provides that a majority of the arbitration panel be from outside the securities industry.⁷³ At first glance, this provision appears to eliminate any bias on the part of the arbitration panel. However, the "absence of clear guidelines for qualifying public arbitrators, . . . and the inclusion in the pool of public arbitrators of persons with clear affiliations with the securities industry"⁷⁴ certainly allows some bias to remain. Furthermore, the provision does not eliminate the bias of the members of the arbitration panel selected from within the securities industry. From a disgruntled investor's point of view (assuming there is a five person arbitration panel, two selected from within the industry and three "neutral" outside arbitrators)⁷⁵ all three of the allegedly "neutral" arbitrators must be convinced of his claim in order for him to succeed. The broker-dealer, who is already perceived to have two votes from the arbitrators within the securities industry, need only convince one of the "neutral" arbitrators in order to defend its position.

Another problem inherent in the arbitration system is that arbitra-

72. UNIFORM CODE OF ARBITRATION (as amended), *reprinted in* Fifth Report of the securities Industry Conference on Arbitration (Apr. 1986) (Exhibit C) in *RESOLVING SECURITIES DISPUTES: ARBITRATION AND LITIGATION* 109 (D. Robins ed. 1986) [hereinafter *Uniform Code of Arbitration*].

The Uniform Code of Arbitration developed by the Conference established a uniform system of arbitration procedures throughout the securities industry. The Code incorporated and harmonized the pre-existing rules of the various self-regulatory organizations. The Code provides for arbitration of disputes between customers and securities industry organizations and individuals under the auspices of the participating self-regulatory organization selected by the customer.

Fifth Report of the Securities Industry Conference on Arbitration (Apr. 1986) in *RESOLVING SECURITIES DISPUTES: ARBITRATION AND LITIGATION* 111 (D. Robins ed. 1986).

73. SEC Letter, *supra* note 52, at 2. Section 8 of the Uniform Code of Arbitration states:

Except as otherwise provided in this Code, in all arbitration matters involving public customers, and where the matter in controversy does not exceed the amount or \$500,000, or where the matter in controversy does not involve or disclose a money claim, the Director of Arbitration shall appoint an arbitration panel which shall consist of no less than three (3) not more than five (5) arbitrators, at least a majority of whom shall not be from the securities industry, unless the public customer requests a panel consisting of at least a majority from the securities industry.

In all arbitration matters involving public customers where the amount in controversy is \$500,000 or more, the Director of Arbitration shall appoint an arbitration panel which shall consist of five (5) arbitrators, *unless the parties agree in writing to a panel of three (3) arbitrators*, at least a majority of whom shall not be a from the securities industry, unless the public customer requests a panel consisting of at least a majority from the securities industry.

UNIFORM CODE OF ARBITRATION, *supra* note 72, § 8 (emphasis in original).

74. SEC Letter, *supra* note 52, at 2; *see McMahon*, 107 S. Ct. at 2355 (Blackmun, J., dissenting)("[I]t is often possible for the 'public' arbitrators to be attorneys or consultants whose clients have been exchange members or SROs.").

75. *See supra* note 73.

tors lack judicial training.⁷⁶ Currently, no training is required for arbitrators.⁷⁷ “[V]irtually no formal training [is given to] arbitrators on matters relating to either arbitration law, including the scope of arbitrators’ authority, relevant state law, or securities law.”⁷⁸ This objection to securities arbitration was raised by the Court in *Wilko*⁷⁹ and is still valid today.

B. Procedural Problems With Securities Arbitration

1. Lack of discovery

The Federal Rules of Civil Procedure provide for liberal discovery between the parties.⁸⁰ Broad and flexible discovery ensures that “prior to trial every party to a civil action is entitled to the disclosure of all relevant information in the possession of any person, unless the information is privileged.”⁸¹ The same liberal rules of discovery applauded under the Federal Rules are not generally available⁸² in arbitration proceedings.⁸³ In fact, discovery is extremely limited in securities arbitration.⁸⁴ “This is true, ‘even though the lack of discovery may be fatal

76. SEC Letter, *supra* note 52, at 4; *see, e.g.*, Fletcher, *supra* note 12, at 454 (and sources cited therein).

77. *See* UNIFORM CODE OF ARBITRATION *supra* note 72.

78. SEC Letter, *supra* note 52, at 4.

79. *Wilko v. Swan*, 346 U.S. 427, 437 (“As the protective provisions of the Securities Act require the exercise of judicial direction to fairly assure their effectiveness, it seems to us that Congress must have intended § 14, [of the Securities Act] to apply to waiver of judicial trial and review.”).

80. C. WRIGHT, *LAW OF FEDERAL COURTS* § 81 at 540 (4th ed. 1983) (Rules 26 to 37 of the Federal Rules of Civil Procedure deal with discovery.).

81. *Id.*

82. If free to contract, the parties *could* contract for full disclosure when contracting for arbitration.

83. Extensive pretrial discovery permitted in the courts (e.g., depositions, written interrogations, bills of particulars, production of documents or things) is not available in securities arbitration proceedings. . . . Because such discovery “tools” can be expensive and burdensome, a stalling tactic, a nuisance, an effort to wear down one’s opponent, and, contrary to the objective of arbitration as an expeditious, cost-effective alternative to the courts.

Robbins, *An Insider’s Guide to Securities Arbitration*, at 14 (1985) in *RESOLVING SECURITIES DISPUTES: ARBITRATION AND LITIGATION* 66 (D. Robins ed. 1986).

84. Section 20 of the Uniform Code of Arbitration as adopted by the securities industry provides:

- (a) The arbitrators and any counsel of record to the proceedings shall have the power of the subpoena process as provided by law. However, the parties shall produce witnesses and present proofs to the fullest extent possible without resort to the issuance of the subpoena process.
- (b) Prior to the first hearing session, the parties shall cooperate in the voluntary exchange of such documents and information as will serve to expedite the arbitration. If the parties agree, they may also submit ad-

to a party's case.'"⁸⁵ The Uniform Code requires the parties to cooperate in the voluntary disclosure of evidence.⁸⁶ If the parties cooperate, this form of discovery is adequate and probably desirable. However, because there are no penalties for failure to cooperate, there is no way to ensure that the parties will cooperate.⁸⁷ While the Uniform Code gives the arbitrators and the parties the power to subpoena documents,⁸⁸ "[u]nder existing rules, the documents that a party requests pursuant to subpoena do not have to be produced until minutes before a hearing is to begin."⁸⁹ The result is that a party may not have enough time to properly prepare its case. As a practical matter, "the requestor does not know whether, on the day of the hearing, he is going to argue over discovery matters only, or whether the arbitrators will proceed to resolve the case on the merits."⁹⁰

The lack of discovery has been cited as an advantage that arbitration has over litigation in that it saves time and money by preventing a "paper trial."⁹¹ In a given situation, however, an investor may need substantial discovery to prove the alleged securities violations. Discovery is particularly important in a securities dispute because the broker-dealer generally has, in its possession, much of the evidence of the violations in its files.⁹²

2. *Lack of a record of the proceedings*

The Uniform Code does not require that a mandatory record of the proceedings be kept.⁹³ Without a record of the proceedings, judicial review of the arbitrators' decision is unduly restricted. While the Arbi-

ditional documents to the Director of Arbitration for forwarding to the arbitrators.

UNIFORM CODE OF ARBITRATION, *supra* note 72, § 20.

85. Katsoris, *supra* note 22, at 287 n.52 (quoting GOLDBERG, A LAWYERS GUIDE TO COMMERCIAL ARBITRATION, § 3.03, at 40 (2d ed. 1983)).

86. UNIFORM CODE OF ARBITRATION, *supra* note 72, § 20(b).

87. SEC Letter, *supra* note 52, at 9. See generally UNIFORM CODE OF ARBITRATION, *supra* note 72.

88. UNIFORM CODE OF ARBITRATION, *supra* note 72, § 20(a).

89. SEC Letter, *supra* note 52, at 9.

90. *Id.*

91. Fletcher, *supra* note 12, at 454.

92. "All the documents are in the hands of the broker-dealer," argues Peter R. Cella, an attorney for investors and a public member of SICA. "Some (firms) are a little reluctant to give documents up, some are downright stonewallers." Salwen, *Investors Swamp Securities-Arbitration System*, Wall St. J., Mar. 15, 1988, at 39, col. 3.

93. Unless requested by the arbitrators or a party or parties to a dispute, no record of an arbitration proceeding shall be kept. If a record is kept, it shall be a verbatim record. If a party or parties to a dispute elect to have the record transcribed, the cost of such transcription shall be borne by the party or parties making the request.

UNIFORM CODE OF ARBITRATION, *supra* note 72, at § 25.

tration Act provides for judicial review of the arbitration proceedings, review is limited to cases where there has been some kind of misconduct by the arbitration panel.⁹⁴ The lack of a record, inhibiting judicial review of the arbitration proceedings, prohibits the correction of any mistakes and thus fails to ensure the protection of investors.

Moreover, because of the lack of any record of previous arbitration proceedings, arbitrators cannot be bound by precedent. In fact, arbitrators are discouraged from writing opinions,⁹⁵ which invites inconsistency in future arbitration decisions. At the present time, the Uniform Code only requires that a record of the proceedings be made when requested by the arbitrators or one of the parties.⁹⁶

C. *The Perception Problem*

In *McMahon*, the Supreme Court found no reason for concern over the quality of arbitration.⁹⁷ It noted that the Securities and Exchange Commission had the power to "ensure that arbitration procedures adequately protect statutory rights."⁹⁸ This, however, is little solace to those investors who perceive the arbitration system as being unfair and have been refused the right to use the courts for redress.

While the arbitration system in the securities industry may or may not be fair to investors, if an investor with a valid claim perceives that arbitration is unfair,⁹⁹ he or she may be less likely to bring the claim to

94. 9 U.S.C. § 10 (1982). A Court may review the arbitration proceedings only:

- (a) Where the award was procured by corruption, fraud, or undue means.
- (b) Where there was evident partiality or corruption in the arbitrators, or either of them.
- (c) Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced.
- (d) Where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.

9 U.S.C. § 10 (1982).

95. *Shearson/American Express, Inc. v. McMahon*, 107 S. Ct. 2332, 2354 (Blackmun, J., dissenting) ("[A]rbitrators are not bound by precedent and are actually discouraged by their association from giving reasons for a decision.").

96. See *supra* note 96 and accompanying text.

97. *McMahon*, 107 S. Ct. at 2341.

98. *Id.*

99. "The industry is identified with the arbitration process, which is looked upon as a club determining the rights of its members." Hoblin, *Broker/Dealer Response to Customer Complaints in Arbitration*, (June 1986) reprinted in *RESOLVING SECURITIES DISPUTES: ARBITRATION AND LITIGATION*, Practice Law Institute, 309, 353 (1986). "[T]he investor has the impression, frequently justified, that his claims are being judged by a forum composed of individuals sympathetic to the securities industry and not drawn from the public." *McMahon*, 107 U.S. at 2355 (Blackmun, J., dissenting).

arbitration. When valid claims are not brought, the purpose of the Securities Act and the Exchange Act—to protect investors—is defeated. Arbitration must not only be fair in fact, but investors must also perceive the arbitration system to be fair in order for the system as a whole to protect investors.¹⁰⁰ Both the substantive problems with the securities arbitration system and the procedural problems previously discussed, contribute to this “perception problem.”

III. PROPOSED CHANGES IN SECURITIES ARBITRATION

In a recent letter to all members of the Securities Industry Conference on Arbitration (SICA), the SEC acknowledged that there were deficiencies in the securities arbitration system and recommended changes to ensure the “fairness and efficiency” of SRO-sponsored arbitration.¹⁰¹ These recommendations were made after an eighteen month study conducted by the SEC and were deemed necessary as a result of the Supreme Court’s decision in *McMahon*.¹⁰² The SEC has recognized that *McMahon* will make arbitration the “primary forum for the resolution of disputes between broker-dealers and investors.”¹⁰³ This will put an increasing demand on a system that was conceived only as an “alternative dispute resolution mechanism.”¹⁰⁴ As discussed earlier in this article, many problems must be resolved before securities arbitration can adequately protect investors. The SEC’s recommendations solve many of these problems but other problems are either inadequately dealt with or are not considered at all.

A. *Problems That SEC Recommendations Solve*

Among the problems that the SEC’s recommendations should solve is the lack of appellate review. The Commission suggests that a record of the proceedings be kept in order to allow appellate review.¹⁰⁵ It is also recommended that the arbitrators be required to write a short opinion of the case including the relevant issues and law. These proposals seem well conceived, certainly needed and should be adopted.

The Commission also realizes there is a problem with discovery in securities arbitration because no “mechanism to ensure that parties cooperate” in the discovery process exists.¹⁰⁶ The Commission’s solution

100. Katsoris, *supra* note 22, at 279, 310.

101. SEC Letter, *supra* note 52, at 1.

102. *Id.*

103. *Id.*

104. *Id.*

105. *Id.* at 8.

106. *Id.* at 9.

is to involve the arbitrators much more in pre-arbitration discovery.¹⁰⁷ This proposal appears to be a good compromise between discovery allowed under the Federal Rules, which may be time consuming and costly, and discovery presently allowed in securities arbitration, which inhibits the investor from preparing his case.

B. Problems That The SEC Recommendations Do Not Solve

The SEC acknowledges a need for impartial arbitrators in securities arbitration.¹⁰⁸ The Commission's recommendations, however, have not gone far enough in this area to ensure investor protection. The main objection from an investor's point of view is that the Commission continues to endorse arbitration panels that consist of a mix of public and industry arbitrators.¹⁰⁹ As has been discussed before, allowing for any number of arbitrators from the securities industry builds bias in favor of broker-dealers into the arbitration system. If the arbitration system is to protect investors, no bias toward either party should be tolerated. To avoid bias, all arbitrators should be chosen from a pool of public arbitrators who have no affiliation with the securities industry.

The Commission has, however, proposed arbitrator training and evaluation. The Commission suggests that training can be accomplished by "institution of a regular newsletter" which would provide general information and keep arbitrators abreast of new developments in the law.¹¹⁰ A comprehensive manual for arbitrators would also be developed which would describe the arbitrator's powers and responsibilities.¹¹¹ These publications along with "instituting a system of written evaluations"¹¹² would aid greatly in ensuring arbitrator competence and should be adopted by the SICA.

The Commission has also voiced concerns about the arbitrator selection process.¹¹³ It is proposed that arbitrators be asked about their disciplinary history, and specifically, if they have been involved in any "theft, the taking of a false oath, or fraud."¹¹⁴ The Commission also suggests the disclosure of any conflicts of interests on the part of a po-

107. *Id.*

108. *Id.* at 2.

109. *Id.*

110. *Id.* at 4.

111. *Id.*

112. *Id.* at 5.

113. Section 11 of the Uniform Code of Arbitration deals with the disclosure that is required of arbitrators. "Each arbitrator shall be required to disclose to the Director of Arbitration any circumstances which might preclude such arbitrator from rendering an objective and impartial determination." UNIFORM CODE OF ARBITRATION, *supra* note 72, § 11.

114. SEC Letter, *supra* note 52, at 3-4.

tential arbitrator.¹¹⁵ Full disclosure by arbitrators is certainly needed not only for the use of the parties when selecting arbitrators but also for use when forming a pool of arbitrators to choose from. The fact that this type of disclosure is not already required is evidence that securities arbitration is in need of reform.

C. Problems That Have Not Yet Been Addressed By The SEC

Among the problems not addressed by the Commission is the concern over adhesion contracts. The perceived unfairness brought about by the use of adhesion contracts could easily be remedied if broker-dealers were required to give investors the choice to either include or exclude arbitration clauses in their contracts. If investors were allowed to bargain freely for arbitration when contracting with broker-dealers, the voluntary aspect usually associated with arbitration would be preserved in securities arbitration.

IV. CONCLUSION

The Supreme Court decision in *McMahon*, makes it clear that pre-dispute arbitration agreements between brokers and investors are enforceable. Following *McMahon* the use of arbitration has increased, putting much more responsibility on the securities arbitration system. Because arbitration is quickly becoming the only recourse investors have against securities violations by broker-dealers, the securities arbitration system must be reevaluated to determine whether or not the system adequately ensures investor protection.

At the present time, problems, both real and perceived, have cast doubts about the fairness of the securities arbitration system. The Securities and Exchange Commission has the authority and the duty to guarantee the adequacy of arbitration. It is now up to the Commission to correct these problems, thus ensuring the system's integrity and protecting investors.

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