Vanderbilt Law Review

Volume 43
Issue 4 *Issue 4 - May 1990*

Article 2

5-1990

Securities Arbitration After McMahon, Rodriguez, and the New Rules: Can Investors' Rights Really Be Protected?

Perry E. Wallace, Jr.

Securities Arbitration After *McMahon, Rodriguez,* and the New Rules: Can Investors' Rights Really Be Protected?

*Perry E. Wallace, Jr.**

* Associate Professor of Law, University of Baltimore School of Law; B. Engr., Vanderbilt University, 1970; J.D., Columbia University School of Law, 1975; Public Arbitrator, National Panel of Arbitrators, New York Stock Exchange, Inc., National Association of Securities Dealers, Inc., and American Arbitration Association. The Author wishes to thank Gene E. Carasick and Kenneth Lasson for reading an earlier draft of this Article and providing helpful critiques as panel members at a faculty seminar in which the Article was presented. Thanks also are extended to faculty members who participated in the seminar, as well as to Seomone Williams and Thomas Corey, who also provided important insights and guidance based on readings of earlier drafts.

I. INTRODUCTION

Securities arbitration[1] is now ascendant as a favored device for resolving disputes between broker-dealers and their customers, and much of this recent status derives from a series of United States Supreme Court decisions.[2] Culminating in *Shearson/American Express, Inc. v. McMahon*[3] and *Rodriguez de Quijas v. Shearson/American Express, Inc.*,[4] these decisions have ended the reign of certain restrictive judicial decisions that previously governed the availability of arbitration under the Federal Arbitration Act (FAA or Arbitration Act).[5] Accordingly, such developments presage a greatly expanded use of arbitration as a future means of resolving disputes between broker-dealers and customers.[6] Indeed, since the Supreme Court placed its impri-

1. Unless otherwise indicated, the scope of this Article shall be confined to securities arbitration based on disputes between small investors—who shall also be referred to as "customers," or "public customers"—and the broker-dealers, also referred to as "brokers" or "firms," whom those investors engage to effect transactions in the securities markets. *See* Chipello, *Street's Skid May Lure Brokers to Take Some for a Ride*, Wall St. J., Dec. 22, 1989, at C1, col. 3 (describing a customer-broker dispute that led to arbitration). "Few financial relationships are as fraught with potential confiict as that between stockbroker and investor. After all, the broker's livelihood depends on generating trading commissions, not automatically on enhancing the investor's returns." *Id.*

2. *See, e.g.*, Rodriguez De Quijas v. Shearson/American Express, Inc., 109 S. Ct. 1917 (1989); Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (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); Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395 (1967).

3. 482 U.S. 220 (1987).

4. 109 S. Ct. 1917 (1989).

5. 9 U.S.C. §§ 1-15 (1988).

6. The prediction that securities arbitration will be employed increasingly gains additional credibility and support when these cases are viewed against the backdrop of certain current economic phenomena. *See, e.g., Arbitration Reform: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 100th Cong., 2d Sess. 265 (1988) [hereinafter *Arbitration Reform Hearings*] (statement of James C. Meyer, Pres., N. Am.

matur on the arbitration process, the arbitral forum already has become the likely, and in some instances the mandated,[7] situs of deliberative proceedings on such conflicts.[8] Logically, the focus of the debate and inquiry on the general subject of brokerage agreement dispute resolution must turn to the nature of this specific process.[9]

Sec. Adm'rs Ass'n). "Use of securities arbitration increased dramatically in 1987 as a result of two key events: the U.S. Supreme Court's June 8, 1987 decision in *Shearson/American Express, Inc. v. McMahon* ("*Shearson*"), which upheld the enforceability of mandatory predispute arbitration agreements, and the stock market crash of October." *Id.* at 266. The effect of the crash subsided in time, but the case law remains. At the same time, however, the parade of events giving rise to increasing numbers of customer-broker disputes, and thus to arbitration cases, continues. *See, e.g., Wall Street's Recession Goes On*, Wash. Post, Dec. 3, 1989, at H3, col. 1 (discussing the recession in the securities industry because of lack of investor confidence due to market shocks, as well as other factors); *Tough Times on Wall Street Dictate Still More Layoffs*, Wall St. J., Nov. 21, 1989, at C1, col. 3. A major concern in such an environment is that the layoffs, cuts in commissions, and other effects of this recession will place pressure on sales departments of brokerage firms, with a correspondingly adverse effect on the ethical behavior of brokers in their treatment of customers. *See, e.g.*, Chipello, *supra* note 1, at C1, col. 3 (stating that "now with Wall Street in a bad slump, investor advocates worry that the temptation for brokers to take advantage of the situation may be greater than ever"); Jasen, *What Investors Don't Know Can Boomerang on Them*, Wall, St. J., Oct. 24, 1989, at C1, col. 3, C14, col. 6 (claiming that broker did not fully inform investor of the various risks associated with zero-coupon certificates of deposit that eventually turned sour, and stating that "[y]ou always have to watch out for yourself [because] [n]o one else will watch out for you"). The latter article discusses an arbitration dispute in which a broker allegedly induced a 100-year-old widow with failing eyesight to liquidate her savings accounts, place them in a brokerage account, and sign a margin, or leveraged, trading agreement. The complaint asserted that the broker made unauthorized and excessive trades, resulting in a sizeable margin call, or deficit, in the trading account. *Id.* at C1, col. 4.

7. The reference is to the controversial mandatory predispute arbitration provisions that are placed in some brokerage contracts. *See, e.g.*, Securities Indus. Ass'n v. Connolly, 883 F.2d 1114 (1st Cir. 1989) (affirming a lower court decision overturning, as violative of the supremacy clause, a Massachusetts regulation purporting to prohibit inclusion of mandatory predispute arbitration provisions); *see also Arbitration Reform Hearings, supra* note 6, at 476 (statement of David S. Ruder, Securities and Exchange Comm'n (SEC) Chairman) (discussing the securities arbitration process and the voluntariness of agreements to arbitrate disputes between broker-dealers and investors).

8. *See Arbitration Reform Hearings, supra* note 6, at Executive Summary (statement of David S. Ruder, SEC Chairman). "The Supreme Court's decision in [*McMahon*] . . . as well as a greater interest by . . . customers in using arbitration, have increased the likelihood that most federal securities law disputes between brokers and their customers will be resolved through arbitration." *Id.*; *see also McMahon*, 482 U.S. at 243 (Blackmun, J., concurring in part and dissenting in part) (stating that the "Court [in its majority opinion] thus approves the abandonment of the judiciary's role in the resolution of claims under the Exchange Act and leaves such claims to the arbitral forum"); Masucci & Morris, *Arbitration at the National Association of Securities Dealers and the New York Stock Exchange*, in 650 P.L.I., SECURITIES ARBITRATION 1989 at 437, 442-44 (corporate law and practice course handbook series for 1989) [hereinafter SECURITIES ARBITRATION 1989]. Between 1980 and 1988, the number of cases received at industry sponsored forums operating under the Uniform Code of Arbitration grew from 830 to 6101. *Id.* at 442. Reasons for the large increase include favorable case law, market events, growth and increased complexity within the financial markets, and increased awareness of and emphasis on securities arbitration. *Id.* at 443.

9. *See, e.g., Arbitration Reform Hearings, supra* note 6, at 170-77 (statement of Professor Norman S. Poser) (noting that in view of the *McMahon* decision, the fairness of arbitration procedures has become a matter of immediate concern); Katsoris, *Securities Arbitration After* McMa-

Given the prominence that securities arbitration is likely to enjoy in the future, probing questions must be asked now regarding the effectiveness, basic fairness, and even legality of the procedures that effectuate it. Underscoring the importance of such inquiry are certain basic facts about securities arbitration in America today. First, this dispute resolution process is most often administered by organizations affiliated with, and indeed part of, the securities industry; and second, the process is predictably preferred by that industry to traditional litigation.[10] Unquestionably, then, the inquiry must begin by addressing the circumstances under which a customer elects or agrees to have disputes resolved through arbitration, and continue through the hearing, final award, and any subsequent judicial challenges. The following questions also should be posed in the interest of assuring both integrity and effec-

---

hon, 16 FORDHAM URB. L.J. 361, 361 (1987-1988). Professor Constantine Katsoris has stated:

> Since *McMahon*, there has been a flurry of activity in, and focus upon, the general area of arbitration of public securities disputes. This activity has generated particular interest in such subjects as: arbitration forums; pretrial procedures and discovery; remedies and relief; composition of panels; training, background and evaluation of arbitrators; and the rendering of written opinions.

Id.; *see also Arbitration Reform Hearings*, *supra* note 6, at 461 (statement of Rep. Edward J. Markey, Chairman, House Subcomm. on Telecommunications and Finance) (reporting on the introduction in the House of the Securities Arbitration Reform Act of 1988, H.R. 4960, 100th Cong., 2d Sess.). H.R. 4960 was introduced on June 30, 1988, by Representative Rick Boucher. *Id.* at 463 (text of H.R. 4960). Representative Boucher introduced the Bill on behalf of "himself, Mr. Markey, and Mr. Dingell." *Id.* Both its introduction and its substance show that the debate surrounding securities brokerage disputes now focuses on the nature of the arbitration process. As Chairman Edward Markey explained at the hearing:

> [T]he bill contains three basic consumer protections. . . one, it makes it unlawful for a broker/dealer to refuse to do business with a customer on the basis of the customer's refusal to sign a pre-dispute arbitration clause; (2) it requires that the arbitration agreement be on a separate page and that it prominently disclose the consequences of signing such a contract, and (3) it provides for fair arbitration procedures for those customers who elect arbitration as the forum for resolution of their disputes.

Id. at 461 (statement of Rep. Edward J. Markey). Chairman Markey indicated that because "the SEC and its staff have apparently suffered a failure of nerve, after receiving a fire storm of criticism [regarding proposed areas of improvement in the arbitration process] from industry lobbyists . . . the possibility of legislation . . . becom[ing] a reality" was necessary to force action by the SEC and the securities industry. *Id.*

10. *See supra* note 9. Underlying Chairman Markey's expressions of concern that the SEC was not fulfilling its duty to improve the arbitration system is the assumption that not only did the securities industry favor arbitration over court litigation, but also that the industry favored it just as it existed. *See* Quinn, *How to Fight Your Broker*, NEWSWEEK, Feb. 1, 1988, at 43 (strongly implying that the courts and the SEC have given in to the industry and that arbitration is basically a proindustry device for limiting a customer's rights under the guise of fair dispute resolution).

> What can you do about unscrupulous brokers? Less than you used to, thanks to a recent proindustry decision by the Supreme Court [*McMahon*]. If you signed an agreement with your brokerage house requiring that disputes be settled by arbitration (as most margin customers do), you may be stuck with it.

Id.

tiveness in the resolution of conflicts through this important vehicle.

Does the brokerage agreement contain an adequate disclosure mechanism that not only will highlight the existence of a predispute arbitration clause in an agreement but also explain its effect to prospective brokerage firm customers?[11] Further, even when such a mechanism is instituted, should there be an express prohibition against the current practice in many brokerage firms of interposing mandatory arbitration clauses as conditions precedent to opening certain types of trading accounts?[12]

Do sufficient and reliable means exist for notifying customers of the available options and proper procedures when disputes arise?[13] In the event the arbitration vehicle is chosen or required, do the options include the possibility of proceeding in nonindustry sponsored arbitral forums such as the American Arbitration Association (AAA)?[14] Should they? Is there an effective and convenient process for acquiring information and documents for case preparation prior to the arbitration hearing?[15] Within the context of the hearing, do the arbitration rules provide the requisite accommodation between the need for flexibility (in the interest of economy, convenience, and ascertainment of truth)

---

11. For a discussion of the importance of disclosure, the issues raised by it, and the effect of the new rules, *see infra* notes 119-80 and accompanying text.

12. The following is an example of a typical mandatory predispute arbitration agreement before the adoption of the new rules:

> ARBITRATION. It is understood that the following agreement to arbitrate does not constitute a waiver of the right to seek a judicial forum where such a waiver would be void under the federal securities laws.
>
> The undersigned agrees, and by carrying an account for the undersigned you agree, that except as inconsistent with the foregoing sentence, *all controversies which may arise between us concerning any transaction or the construction, performance or breach of this or any other agreement between us, whether entered into prior, on, or subsequent to the date hereof, shall be determined by arbitration* in accordance with the rules, then in effect, of the National Association of Securities Dealers, Inc., the Board of Governors of the New York Stock Exchange, Inc., or the Board of Governors of the American Stock Exchange, Inc., as you may elect. If you do not make such election by registered mail addressed to [the brokerage firm's legal and compliance department in New York City], within five days after demand by [the brokerage firm] that you make such election, then [the brokerage firm] may make such election. Judgment upon any award rendered by the arbitrators may be entered in any court having jurisdiction thereof.

This provision appeared in the body of the trading agreement in type of the same character and boldness as the other provisions of the agreement. For a discussion of mandatory predispute arbitration agreements, see *infra* notes 121-43, 151-80 and accompanying text.

13. *See infra* notes 119-50 and accompanying text.

14. *See infra* notes 181-202 and accompanying text.

15. Prehearing preparation is vital to full and fair presentation of the matters in dispute. For a discussion of the provisions of the new rules that address the hearing preparation phase of arbitration, see *infra* notes 203-10; *see also* Robbins, *A Practitioner's Guide to Securities Arbitration*, in SECURITIES ARBITRATION 1989, *supra* note 8, at 15, 124 (noting that "[a]djudication by ambush had always been the major weakness of arbitration").

on the one hand, and definiteness, thoroughness, and decorum, on the other?[16] Additionally, are there effective means of balancing the competing but important policies of avoiding arbitrator conflicts of interest, and retaining arbitrators with sufficient experience to understand the complex workings of the capital markets and the market regulatory system, brokerage firm operations and procedures, and the ever expanding panoply of investment devices?[17]

Additional questions arise with respect to the application of legal theories underlying claims brought to arbitration. To what extent, for example, do the arbitrators understand the pertinent legal theories? Even if they understand these theories, do they actively apply them? Is anything lost if the theories are not applied specifically and knowledgeably? That is, should the arbitrators' judgments based on what is "fair," "just," or merely "sensible" be a sufficient basis for an award? Should written opinions accompany arbitration awards, and would such opinions serve the public interest? More specifically, would written opinions provide guidance to the securities industry and its current and prospective customers concerning what are proper brokerage and customer-investor standards of conduct? Would such opinions generate a known and coherent body of jurisprudence in the field and specify the basis of the decision to facilitate subsequent judicial review of awards in proper instances? Are large, complex cases more deserving of strict applications of law, and perhaps more juridical evidentiary processes? How might such processes be implemented? In this regard, should some matters be referred by arbitration panels to the courts, and if so, what standards should apply for referring appropriate cases?[18]

The questions set out above are among the more critical ones that have generated extensive discussions by the Securities and Exchange

---

16. The classic advantages of arbitration are that it is convenient, economical, and generally not laden with the complications and intricacies of court litigation. *See, e.g.*, *Arbitration Reform Hearings*, *supra* note 6, at 6 (statement of Stephen L. Hammerman, Executive Vice President, and General Counsel, Merrill Lynch & Co.) (stating that "[a]rbitration of securities disputes brings customers and firms prompt, affordable and just results; moreover, arbitration facilities are more accessible to investors than the federal courts"). On the other hand, the more flexible, less stringent nature of these proceedings, along with other features, are said by many to obscure the effectiveness of the process. *See* Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 257-58 (Blackmun, J., concurring in part and dissenting in part).

17. The thorny problem of conflicts of interest with respect to the arbitrator panel has received considerable attention. It is the subject of amendments that will be analyzed in this Article. *See infra* notes 195-224.

18. *See* Robbins, *supra* note 15, in SECURITIES ARBITRATION 1989, *supra* note 8, at 166; *see also Arbitration Reform Hearings*, *supra* note 6, at 478-82. Chairman Ruder has requested the SROs to evaluate many of these issues in order to promulgate effective rules governing the arbitration process.

Commission (SEC or Commission);[19] securities industry organizations such as the Securities Industry Conference on Arbitration (SICA), the Securities Industry Association (SIA), and the self-regulatory organizations (SROs);[20] and various other organizations. These discussions have culminated in the recent approval by the SEC of substantial revisions to the previous regulatory scheme for arbitration of customer brokerage disputes in industry sponsored arbitration forums.[21] This Article is intended as a contribution to the ongoing attempts at improving the arbitration process. The discussion will concentrate mainly on the new rules and recent decisional law; additionally, however, treatment will be accorded subjects not necessarily raised in those rules and decisions.

This Article has four main theses. First, because the Supreme Court has skewed the avenues of choice for resolving disputes between broker-dealers and customers decidedly in favor of securities arbitration, the arbitration system—most particularly those systems conducted by the securities industry itself—must sustain a heavy burden to create and effectuate an absolutely fair, efficient, and economical process. Second, the new arbitration rules, as well as the enthusiasm and resolve with which the industry approached these revisions of the prior rules, bespeak a significantly improved regime that is capable of meeting that burden. Third, even this new regime can be improved, and in the important, over-arching interests of investor protection, investor confidence, and the integrity of capital markets, additional revisions such as the ones suggested in this Article should be considered carefully. And fourth, the industry, the SEC, and the public must continue to monitor and evaluate the securities arbitration process.

Part II of this Article explores the historical development of securities arbitration, initially analyzing its statutory underpinnings and the evolution of applicable case law, and then explaining the complex, interactive regulatory roles of the SROs and the SEC in the arbitration process. The dynamic interplay of economic, judicial, legislative, and regulatory forces in recent years has imposed upon securities arbitration the daunting burden of protecting the rights of investors and their confidence in the capital markets without inhibiting the process of national economic growth through rigorous investment and finance activi-

---

19. The SEC has the statutory authority and mandate to regulate the securities markets, but has given wide latitude to the securities industry, through its self-regulatory organizations, to make and enforce the industry's own rules. *See McMahon*, 282 U.S. at 233; *infra* notes 102-18 and accompanying text.

20. For more extensive discussions of the role of these organizations in regulating the securities markets, see *infra* notes 97-101 and accompanying text.

21. Exchange Act Release No. 26,805 [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,414, at 80.099 (May 10, 1989).

ties. Part III discusses issues that are crucial to the improvement of arbitration procedures and their administration and sets forth specific recommendations. The recommendations focus primarily on the need, in certain instances, for a prohibition against mandatory arbitration clauses; the desirability of allowing investors to choose to arbitrate before the American Arbitration Association; the importance of certain additional protections against arbitrator conflicts of interest; and the need to develop rules governing the conduct of complex cases, including the referral of cases to the courts.

II. THE DEVELOPMENT OF SECURITIES ARBITRATION[22]

A. *Statutory and Judicial Background*

The Federal Arbitration Act[23] was intended to " 'revers[e] centuries of judicial hostility to arbitration agreements' " by " 'plac[ing] arbitration agreements "upon the same footing as other contracts." ' "[24] Section 2 of the Act provides, in pertinent part:

> A written provision in . . . a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract . . . or the refusal to perform the [contract] . . . or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract . . . or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.[25]

Further, section 3 of the Act provides that when a court determines an issue before it is referable to arbitration, the court must stay its proceedings.[26] Finally, section 4 of the Act allows a court to issue an order

---

22. Rather than replicate the development of this history already performed in other works, this section simply summarizes that history in order to provide a reference point for discussions later in this Article. For more extensive treatment of the development of the law in this area, see, e.g., Bedell, Harrison & Harvey, *The* McMahon *Mandate: Compulsory Arbitration of Securities and RICO Claims*, 19 LOY. U. CHI. L.J. 1 (1987); Note, Shearson/American Express v. McMahon*: The Diminishing Role of Courts in Securities Disputes*, 1988 B.Y.U. L. REV. 443; Comment, *Securities Arbitration—The Supreme Court Resolves the Issue of Enforceability of Mandatory Arbitration Clauses in Brokerage Contracts:* Shearson/American Express, Inc. v. McMahon, 73 IOWA L. REV. 449 (1988).

23. 9 U.S.C. §§ 1-15 (1988).

24. *McMahon*, 282 U.S. at 225-26 (quoting Scherk v. Alberto-Culver Co., 417 U.S. 506, 510-11 (1974) (quoting H.R. REP. No. 96, 68th Cong., 1st Sess. 1 (1924))). H.R. REP. No. 96 states, in pertinent part:

> Arbitration agreements are purely matters of contract, and the effect of the bill is simply to make the contracting parties live up to [their] agreement[s]. [They] can no longer refuse to perform [their] contract[s] when it becomes disadvantageous to [them]. An arbitration agreement is placed upon the same footing as other contracts, where it belongs.

H.R. REP. No. 96, *supra*, at 2.

25. 9 U.S.C. § 2 (1988).

26. *Id.* § 3; *see McMahon*, 282 U.S. at 226; Comment, *Predispute Arbitration Clauses in a Brokerage Firm's Customer Account Agreement*, 14 WM. MITCHELL L. REV. 907, 910 (1988).

compelling arbitration when there has been a "failure, neglect, or refusal" to cooperate with the arbitration agreement.[27]

Despite the clear language of the Act and its legislative history, courts frequently declined to enforce securities arbitration provisions until well into the 1970s.[28] *Wilko v. Swan*[29] is the most significant of the cases reflecting this judicial reluctance.

In *Wilko*[30] the Supreme Court held unenforceable a predispute agreement to compel arbitration of a claim under section 12(2) of the Securities Act of 1933 (Securities Act).[31] The Court's holding turned on section 14 of the Securities Act, which declares void any "stipulation" to waive compliance with that statute.[32] The *Wilko* Court emphasized that Congress enacted section 12 to provide investors with a "special right to recover for misrepresentation which differs substantially from the common-law action in that the seller is made to assume the burden of proving lack of scienter."[33] Further, the Court observed that section 22 of the Securities Act,[34] by conferring broad jurisdiction to sue, affords substantial opportunities to investors to vindicate that right.[35] Thus, opined the Court, notwithstanding the congressional policy of the Arbitration Act to provide for expeditious and economical relief in

---

27. 9 U.S.C. § 4 (1988).

28. *See, e.g.*, Wilko v. Swan, 346 U.S. 427 (1953); Surman v. Merrill Lynch, Pierce, Fenner & Smith, 733 F.2d 59 (8th Cir. 1984); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Moore, 590 F.2d 823 (10th Cir. 1978); Sihley v. Tandy Corp., 543 F.2d 540 (5th Cir. 1976), *cert. denied*, 434 U.S. 824 (1977); Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 538 F.2d 532 (3d Cir.), *cert. denied*, 429 U.S. 1010 (1976).

29. 346 U.S. 427 (1953).

30. *Wilko*, 346 U.S. at 434-35.

31. 15 U.S.C. § 77l(2) (1988). Section 12(2) provides in pertinent part:

> Any person who . . . offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him . . . .

Id.

32. *Id.* Section 14, 15 U.S.C. § 77n, provides that "[a]ny condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void." 15 U.S.C. § 77n (1988).

33. *Wilko*, 346 U.S. at 431.

34. 15 U.S.C. § 77v (1988).

35. *Wilko*, 346 U.S. at 431. Specifically, the Court stated:

> The Act's special right is enforceable in any court of competent jurisdiction—federal or state—and removal from a state court is prohibited. If suit be brought in a federal court, the purchaser has a wide choice of venue, the privilege of nation-wide service of process and the jurisdictional $3,000 requirement of diversity cases is inapplicable.

Id.

these disputes, the policy in the Securities Act promoting investor protection through provision of a judicial forum for dispute resolution should prevail.[36]

After *Wilko*, federal courts extended that case's nonarbitrability holding to other sections of the Securities Act, as well as to the Securities Exchange Act of 1934 (Exchange Act).[37] This trend, however, eventually began to reverse, at least with respect to Exchange Act arbitration enforceability.

In *Scherk v. Alberto-Culver Co.*,[38] for example, the Supreme Court upheld the arbitrability of section 10(b) Exchange Act claims arising out of international transactions.[39] Although the decision turned essentially on the nature and circumstances of international commerce, certain dictum in Justice Potter Stewart's majority opinion was particularly pertinent to advancing the trend favoring greater availability of arbitration: "[A] colorable argument could be made that even the semantic reasoning of the *Wilko* opinion does not control the case before us."[40]

Thus, the Court implied that there may not be sufficient similarity in the Securities Act and the Exchange Act to provide a basis for rationally extending *Wilko* to Exchange Act cases. In fact, the Court noted several significant differences: section 10(b) claims were implied rather than express; the Exchange Act does not provide the broad grant of state and federal jurisdiction as does the Securities Act; and the Exchange Act does not create a "special right."[41] All of these considerations were central to the holding in *Wilko*.[42]

---

36. *Id.* at 438.

37. *See, e.g.*, Raiford v. Buslease Inc., 745 F.2d 1419 (11th Cir. 1984); Surman v. Merrill Lynch, Pierce, Fenner & Smith, 733 F.2d 59 (8th Cir. 1984); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017 (6th Cir. 1979); Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 538 F.2d 532 (3d Cir.), *cert. denied*, 429 U.S. 1010 (1976). Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) (1988), has been the real focus of the case development in this area. Section 10(b) provides as follows:

> It sball 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—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

38. 417 U.S. 506 (1974).

39. *Id.* at 519-20.

40. *Id.* at 513.

41. *Id.* at 513-14.

42. *See Wilko*, 346 U.S. at 431, 434-38.

Dean Witter Reynolds, Inc. v. Byrd[43] marked another significant development in the judicial trend favoring arbitration. *Byrd* involved claims under state law and under sections 10(b), 15(c), and 20 of the Exchange Act in federal district court by a plaintiff who had invested, and quickly lost, over one hundred thousand dollars.[44] Dean Witter, assuming the Exchange Act claims were nonarbitrable as a result of *Wilko*, moved to sever only the state claims, requesting that action on those arbitrable state claims be stayed until the federal claims were resolved.[45]

Directly at issue was the applicability of the "intertwining doctrine," developed by the Fifth Circuit and adopted at the time by the Ninth and Eleventh Circuits.[46] Under this doctrine, when arbitrable and nonarbitrable claims were factually and legally intertwined, then, notwithstanding the strong federal policy of the Arbitration Act favoring arbitration, courts should decline to require arbitration in order to preserve exclusive jurisdiction over the nonarbitrable federal securities claims.[47]

The *Byrd* Court rejected the intertwining doctrine. The Court stated that in the absence of a policy to the contrary expressed in another federal act or its legislative history, the Arbitration Act's presumption of arbitrability required that arbitration be allowed, in spite of the specter of judicial inefficiency through bifurcated proceedings, piecemeal litigation, increased expense, and other similar factors.[48]

Significantly, the issue regarding applicability of the *Wilko* holding to Exchange Act claims also arose in *Byrd*, albeit collaterally. Although the majority opinion stated in a footnote that it was not deciding this issue, the opinion observed that "*Wilko* has retained considerable vitality in the lower federal courts," those courts in several instances having applied *Wilko* to section 10(b) Exchange Act claims.[49] Justice Byron White's concurring opinion disagreed, however, noting that "*Wilko*'s solicitude for . . . the 'special right' established by Congress . . . is not necessarily appropriate where the cause of action is judicially implied and not so different from the common-law action."[50] Further, noted Justice White, "the question [of *Wilko*'s applicability] remains open, and the contrary holdings of the lower courts must be viewed with some

43. 470 U.S. 213 (1985).
44. *Id.* at 214.
45. *Id.* at 215.
46. *See, e.g.*, Sibley v. Tandy Corp., 543 F.2d 540, 544 (5th Cir. 1976), *cert. denied*, 434 U.S. 824 (1977).
47. *Id.*
48. *Byrd*, 470 U.S. at 217-21.
49. *Id.* at 215 n.1.
50. *Id.* at 225 (White, J., concurring) (citation omitted).

doubt."[51]

Mitsubishi Motors Corp. v. Solar Chrysler-Plymouth,[52] *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*,[53] and *Southland Corp. v. Keating*,[54] all supplemented *Byrd* by stressing the strong federal policy creating a preference for arbitration. Nonetheless, there had been no actual holding by the Supreme Court specifically resolving the question of whether predispute arbitration clauses were enforceable when the claim underlying the dispute was based on the Exchange Act. The *McMahon* case addressed and answered that question directly.

In *McMahon* the plaintiffs filed claims against the defendants, a brokerage firm and one of its registered representatives, based on state law, section 10(b) of the Exchange Act, and section 1962 of the Racketeer Infiuenced and Corrupt Organizations Act (RICO).[55] The complaint alleged churning,[56] unsuitability,[57] and misrepresentation.[58] The defendants moved to enforce the arbitration clause of the brokerage agreement. Significantly, the defendants' motion sought to have all claims arbitrated, including those under section 10(b) and RICO, thus placing directly in issue both the viability and the scope of *Wilko*.[59]

Holding that the section 10(b) and RICO claims were arbitrable, Justice Sandra Day O'Connor reaffirmed the policy of the FAA favoring arbitration.[60] O'Connor stressed that a party opposing arbitration must demonstrate a conflicting or "contrary congressional command . . . 'deducible from [the statute's] text or legislative history' " in order to

---

51. *Id.*

52. 473 U.S. 614 (1985).

53. 460 U.S. 1 (1983).

54. 465 U.S. 1 (1984).

55. Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 223 (1987).

56. *Id.* Churning is the practice whereby a broker makes excessive trades in a customer's account solely to generate brokerage commissions. Thus the "broker[s] cause[] securities in [their] customer's account to be bought and sold with a frequency too great in light of the customer's financial needs, resources and investment objective." Robbins, *supra* note 15, in SECURITIES ARBITRATION 1989, supra note 8, at 76; *see also* Poser, *Options Account Fraud: Securities Churning in a New Context*, 39 BUS. LAW. 571, 573 (1984) (quoted in Robbins, *supra* note 15, in SECURITIES ARBITRATION 1989, *supra* note 8, at 76). "Churning occurs because many securities brokers play a dual role as both investment advisers and salespersons and because of the compensation system used in the securities industry." *Id. See generally* Mihara v. Dean Witter & Co., 619 F.2d 814 (9th Cir. 1980); Rush v. Oppenheimer & Co., 592 F. Supp. 1108, 1112 (S.D.N.Y. 1984).

57. *McMahon*, 282 U.S. at 223. Unsuitability refers to the failure of a broker to match the customer with the proper investment, considering the customer's financial and other pertinent circumstances. *See* Clark v. John Lamula Investors, Inc., 583 F.2d 594, 600-01 (2d Cir. 1978); Zaretsky v. E.F. Hutton & Co., 509 F. Supp. 68, 75-76 (S.D.N.Y. 1981); Poser, *Civil Liability for Unsuitable Recommendations*, 19 REV. SEC. & COMMODITIES REG. 67 (1986); *see also infra* note 174.

58. *McMahon*, 282 U.S. at 223.

59. *Id.*

60. *Id.* at 226.

override that Act's mandate.[61] The majority stated that, contrary to the statutory scheme of the Securities Act of 1933 on which *Wilko* was based, section 29(a) of the Exchange Act,[62] "which declares void '[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of [the Act],'" only prohibits waivers of compliance with the Exchange Act's provisions, and not waivers of jurisdiction under section 27.[63] *Wilko* was not seen as compelling a different result, because the Court in *Wilko* held that a "waiver [through arbitration] of the 'right to select the judicial forum' was unenforceable only because arbitration was judged inadequate to enforce the statutory rights created by § 12(2) [of the Securities Act]."[64]

The *McMahon* Court also rejected the claim that giving effect to arbitration provisions constitutes an impermissible waiver of the Exchange Act's substantive protections.[65] The Court addressed numerous criticisms leveled at the arbitration process, both in *Wilko* and generally, and concluded that arbitration does not effect a waiver of Exchange Act protections.[66] Interestingly, the Court expressly declined to overrule "*Wilko*'s contrary conclusion under the Securities Act," citing "*stare decisis* concerns."[67] Nonetheless, the Court refused to apply *Wilko*'s reasoning to the Exchange Act because of intervening regulatory developments.[68]

The Court also refused to agree with the claim that Congress's failure to address the issue of arbitrability of Exchange Act claims when it amended the Exchange Act in 1975 was evidence of congressional "ratification of *Wilko*'s extension to Exchange Act claims."[69] Finally, the RICO claims were held arbitrable on the grounds that "there is no inherent conflict between arbitration and the purposes underlying [section] 1964(c) [of RICO]. Moreover, nothing in RICO's text or legislative history otherwise demonstrates congressional intent to make an excep-

---

61. *Id.* (quoting Mitsubishi Motors Corp. v. Soler Cbrysler-Plymouth, 473 U.S. 614, 628 (1985)).

62. 15 U.S.C. § 78cc(a) (1988).

63. *McMahon*, 282 U.S. at 227 (quoting 15 U.S.C. § 78cc(a) (1988)).

64. *Id.* at 228-29 (citation omitted) (quoting Wilko v. Swan, 346 U.S. 427, 435 (1953)).

65. *Id.* at 229-34.

66. *Id.* at 231-34. The Court emphasized arbitration's improved regulatory underpinnings and judicial rejection of many of tbe criticisms of arbitration made in *Wilko*. *Id.*

67. *Id.* at 234 (empbasis in original). The Court held tbat "[w]hile *stare decisis* concerns may counsel against upsetting *Wilko*'s contrary conclusion under the Securities Act, we refuse to extend *Wilko*'s reasoning to tbe Excbange Act in light of these intervening regulatory developments." *Id.* (emphasis in original).

68. *Id.*

69. *Id.* at 236. Specifically, tbe Court held "[t]be *Wilko* issue was left to the courts: it was unaffected by the amendment . . . ." *Id.* at 238.

tion to the Arbitration Act for RICO claims."[70]

After the *McMahon* holding, arbitration's centrality to brokerage dispute resolution was uncontestable, and therefore its integrity as a process had to be assured. As will be discussed below, earlier initiatives to study and improve the process continued, but at more accelerated and intense levels.[71] In *McMahon*'s wake, however, the Supreme Court handed down a decision that some interpreted as a retreat from its previous, expansive rulings.

In *Volt Information Sciences, Inc. v. Board of Trustees*[72] the Supreme Court upheld a state court decision that denied a motion to compel arbitration and granted a countervailing motion to stay arbitration. The state court had based its holding on a state statute allowing such a stay pending resolution of related litigation between a party to the arbitration agreement and third parties not bound by the agreement.[73]

The *Volt* case centered on a dispute over a California construction contract between the Volt company and a university; under the contract, Volt was to install a system of electrical conduits on the university campus. The contract contained, in addition to an arbitration agreement, a choice of law clause providing that "[t]he Contract shall be governed by the law of the place where the Project is located."[74] When a dispute arose over the contract's terms, Volt demanded arbitration; the university, on the other hand, filed suit in California Superior Court, alleging fraud and breach of contract and joining two other parties from whom the university sought indemnity.[75] The motion to stay arbitration, filed in response to the Volt company's motion to compel arbitration, was based on a California Civil Procedure Code provision permitting a court to stay arbitration pending resolution of related litigation between a party to the arbitration agreement and third parties not bound by it, when "there is a possibility of conflicting rulings on a common issue of law or fact."[76]

The Court accepted, without independent evaluation, the lower

---

70. *Id.* at 242.

71. *See infra* notes 97-118 and accompanying text.

72. 109 S. Ct. 1248 (1989).

73. *Id.* at 1251-52.

74. *Id.* at 1251. The arbitration agreement provided, in pertinent part:

> All claims, disputes and other matters in question between the parties to this contract, arising out of or relating to this contract or the breach thereof, shall be decided by arbitration in accordance with the Construction Industry Arbitration Rules of the American Arbitration Association then prevailing unless the parties mutually agreed [sic] otherwise. . . . This agreement to arbitrate . . . shall be specifically enforceable under the prevailing arbitration law.

Id. at 1251 n.1.

75. *Id.* at 1251.

76. *Id.* at 1251 n.3 (quoting CAL. CIV. PROC. CODE § 1281.2(c) (West 1982)).

state court's conclusion that the parties intended the choice of law clause to incorporate the California statutory provision on arbitration.[77] Thus, agreed the Court, the parties intended for a stay of arbitration to apply in circumstances contemplated under the state statute. The state court's interpretation of the choice of law clause did not waive the parties' rights under the FAA. Specifically, the Court held that "[section] 4 of the FAA does not confer a right to compel arbitration of any dispute at any time; it confers only the right to obtain an order directing that 'arbitration proceed in the manner provided for in [the parties'] agreement.' "[78]

The Court also rejected arguments that the state court's interpretation violates the strong federal policy, abundantly and clearly expressed in its recent cases, favoring arbitration and preempting conflicting state laws.[79] Indeed, the Court's surprisingly restrictive characterization of prior case law was seen by some observers as a retrenchment.[80]

The dissent in *Volt* observed that "[a]pplying the California procedural rule, which stays arbitration while litigation of the same issue goes forward, means simply that the parties' dispute will be litigated rather than arbitrated."[81] Surely the majority were aware of this ultimate outcome; they were equally aware of the numerous arguments forcefully made in the dissent.[82]

It is not clear what interests the Court sought to promote in *Volt*. Perhaps the Court viewed state law as deserving of regard, if not deference, in such circumstances. Perhaps the majority truly believed that the parties subjectively intended that the particular state law provision at issue should apply, although such an intent does not appear likely as

---

77. *Id.* at 1253-54.

78. *Id.* at 1253 (quoting 9 U.S.C. § 4 (1988) (emphasis in original)).

79. *Id.*

80. *Id.* at 1254-55.

81. *Id.* at 1259-60 (Brennan, J., dissenting).

82. The dissent opined that the majority clearly was entitled to review the state court's construction of the choice of law clause. This power of review exists (1) because the Court always has reserved the right to conduct its own independent review of private contract law, notwithstanding the fact that interpretation of private contracts is ordinarily a question of state law, when there are federal rights to be protected, *id.* at 1257, and (2) because the FAA creates substantive federal law that is intertwined with the state law issues, meaning that the state court judgment cannot rest on an "adequate and independent state ground" such as could bar review by the Supreme Court. *Id.* at 1259-60. Additionally, the dissent expressed serious doubt as to whether the parties even remotely intended the interpretation rendered by the majority, and disagreed vehemently that the majority's opinion reflects the " 'healthy regard for tbe federal policy favoring arbitration,' " *id.* at 1259 (quoting Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983)), or the command that the parties' " 'intentions [be] generously construed as to issues of arbitrability,' " *id.* at 1260 (quoting Mitsubishi Motors v. Soler Chrysler-Plymouth, 473 U.S. 614, 626 (1985)).

a practical matter.[83] In any event, whether that decision is viewed as an aberration, or as simply distinguishable, the Supreme Court soon returned to its more general theme of direct and unequivocal support for arbitration in *Rodriguez de Quijas v. Shearson/American Express, Inc.*[84]

In *Rodriguez* the petitioners were individuals who had invested approximately four hundred thousand dollars in securities through the respondent Shearson/American Express's brokerage department.[85] When the investment turned sour, the petitioners brought suit in federal district court alleging their money was lost through unauthorized and fraudulent transactions. The complaint asserted claims under federal and state law, including violations under section 12(2) of the Securities Act.[86] The district court ordered that all claims be submitted to arbitration except those under section 12(2) of the Securities Act, which, the court stated, were required to be litigated in court under the holding in *Wilko*.[87] The Court of Appeals for the Fifth Circuit reversed, concluding that Supreme Court decisions subsequent to *Wilko* have reduced that case's holding to "obsolescence."[88]

On appeal, the Supreme Court took the opportunity to reverse *Wilko*. The Court found "that *Wilko* was incorrectly decided and is inconsistent with the prevailing uniform construction of other federal statutes governing arbitration agreements in the setting of business transactions."[89]

The Supreme Court recognized in *Rodriguez* that the *Wilko* Court faced a "difficult" decision because of the competing interests of the Securities Act, which seeks to ensure a high level of protection for investors in securities, and the FAA, "which strongly favors the enforce-

---

83. It is possible, although not probable, that the parties specifically discussed the application of the specific state law provision at issue when they negotiated and agreed upon the terms of the overall contract. *See Volt*, 109 S. Ct. at 1260 (Brennan, J., dissenting). "[T]here is no extrinsic evidence of . . . [the parties'] intent . . . . [T]he provision of the contract at issue here was not one that these parties drafted themselves." *Id.*

For a discussion of the opinion of the United States Court of Appeals for the First Circuit in Securities Industry Ass'n v. Connolly, 883 F.2d 1114 (1st Cir. 1989), which sets forth the rationale for that court's conclusion that the *Volt* ruling is consistent with Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987), and Rodriguez de Quijas v. Shearson/American Express, Inc., 109 S. Ct. 1917 (1989), see *infra* notes 125-43 and accompanying text.

84. 109 S. Ct. 1917 (1989).

85. *Id.* at 1918.

86. *Id.* at 1919.

87. *Id.*; *see* Wilko v. Swan, 346 U.S. 427 (1953).

88. *See Rodriguez*, 109 S. Ct. at 1919; Rodriguez de Quijas v. Shearson/American Express, Inc., 845 F.2d 1296 (5th Cir. 1988), *aff'd*, 109 S. Ct. 1917 (1989). The Fifth Circuit followed its decision in Noble v. Drexel, Burnham, Lambert, Inc., 823 F.2d 849, 850 n.3 (5th Cir. 1987) (stating that "*McMahon* undercuts every aspect of *Wilko*").

89. *Rodriguez*, 109 S. Ct. at 1922.

ment of agreements to arbitrate as a means of securing 'prompt, economical and adequate solution of controversies.' "[90] The *Rodriguez* Court immediately seized upon the *Wilko* Court's observation that these competing interests are " 'not easily reconcilable.' "[91] The Court then recounted the evolutionary path of court decisions, from what Judge Jerome Frank of the Second Circuit Court of Appeals called "the old judicial hostility to arbitration," through the steady succession of cases eroding that view, culminating in the *McMahon* decision.[92]

The *Rodriguez* Court observed that the *Wilko* decision was founded, first, on the belief that " 'arbitration lacks the certainty of a suit at law under the [Securities] Act to enforce [the buyer's] rights,' " and second, on the "particularly valuable feature of the Securities Act" providing buyers with " 'a wider choice of courts and venue' " than is ordinarily true.[93] To these contentions, the Court replied:

> Once the outmoded presumption of disfavoring arbitration proceedings is set to one side, it becomes clear that the right to select the judicial forum and the wider choice of courts are not such essential features of the Securities Act that [section] 14 is properly construed to bar any waiver of these provisions. Nor are they so critical that they cannot be waived under the rationale that the Securities Act was intended to place buyers of securities on an equal footing with sellers.[94]

Thus, *Rodriguez* overturned *Wilko* for two important reasons. First, the Court sought " 'to correct a seriously erroneous interpretation of statutory language."[95] Second, it also wanted to remove the inconsistency in treatment of claims under the two securities statutes that " 'constitute interrelated components of the federal regulatory scheme governing transactions in securities.' "[96]

B. Regulatory Background

1. The Self-Regulatory Role of the Securities Industry

The most important regulatory developments in arbitration began in 1976, when the SEC's Office of Consumer Affairs, in pursuit of the Commission's statutory mandate to regulate the securities markets, sought to eliminate the variations in the SROs' arbitration rules. The SEC solicited comments on the advisability of establishing a "uniform

---

90. *Id.* at 1919 (quoting *Wilko*, 346 U.S. at 438).

91. *Id.* (quoting *Wilko*, 346 U.S. at 438).

92. *See id.* at 1920 (quoting Kulukundis Shipping Co. v. Amtorg Trading Corp., 126 F.2d 978, 985 (2d Cir. 1942)).

93. *Id.* at 1919-20 (quoting *Wilko*, 346 U.S. at 432, 435).

94. *Id.* at 1920.

95. *See* Neeseman, *After* McMahon *and* Rodriguez*: The State Of The Law*, in SECURITIES ARBITRATION 1989, *supra* note 8, at 217, 239 (quoting *Rodriguez*, 109 S. Ct. at 1922).

96. *Rodriguez*, 109 S. Ct. at 1922 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 206 (1976)).

system of dispute grievance procedures for the adjudication of small claims."[97] Receipt of comments generated concern from the Commission that there is an "absence of a fully effective, responsive system for the assertion and resolution of investor complaints with registered brokerage firms . . . [and that] the individual investors may not have, in every respect, the measure of protection anticipated by the federal securities laws."[98]

In April 1977 the securities industry formed the Securities Industry Conference on Arbitration, which today consists of ten SROs, the Securities Industry Association (a major trade association for the securities industry), and four members of the public.[99] Eventually, SICA developed a Uniform Code of Arbitration (Code) that the SROs then adopted with the SEC's approval. The Code reputedly incorporates and harmonizes various prior formal and informal rules, culminating in a uniform set of procedures for initiating, processing, and resolving claims.[100] As amended from time to time, the Code serves as the basic source of rules on arbitration procedures in customer disputes before the SROs.[101]

2. The Role of the Securities and Exchange Commission

Although the above described deference to securities industry expertise in the establishment of arbitration procedures has been the SEC's usual practice,[102] the ultimate responsibility and authority for

---

97. Setting Disputes Between Customers and Broker-Dealers, Exchange Act Release No. 12,528 (June 9, 1976), *reprinted in* 9 SEC DOCKET 833-35 (1976); *see* Katsoris, *The Arbitration of a Public Securities Dispute*, 53 FORDHAM L. REV. 279, 283 (1984); Katsoris, *supra* note 9, at 326. For a brief description of the SEC's broad regulatory powers in this area, see *infra* note 99.

98. Exchange Act Release No. 12,974 [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,806, at 87,102 (Nov. 11, 1976).

99. *See* Klein & Harkins, *Significance for Investors and the SEC*, 20 REV. SEC. & COMMODITIES REG. 195,198 (1987). The following SROs are SICA members: the American (AMEX), Boston, Cincinnati, Midwest, New York (NYSE), Pacific, and Philadelphia Stock Exchanges, the Chicago Board Options Exchange, the Municipal Securities Rulemaking Board, and the National Association of Securities Dealers, Inc. (NASD). *See* Katsoris, *supra* note 97, at 283 n.13; Katsoris, *supra* note 9, at 362 n.8.

100. *See* Katsoris, *supra* note 97, at 284; Katsoris, *supra* note 9, at 363-64; Klein & Harkins, *supra* note 99, at 198. SICA also prepared an explanatory Procedures Booklet for prospective claimants. *See* Katsoris, *supra* note 97, at 284.

101. *See supra* notes 99-100.

102. *See* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 684-85 (1983).

> Although appropriate provisions on registration and fraud-prevention furnish an indispensable foundation for an adequate system of control, they must be supplemented by regulation on an ethical plane in order "to protect the investor and the honest dealer alike from dishonest and unfair practices by the submarginal element in the industry" and "to cope with those methods of doing business which, while technically outside the area of definite illegality, are nevertheless unfair both to customer and to decent competitor, and are seriously damaging to the mechanism of the free and open market." And regulation of the *ethics* of an industry

regulating securities market activities still reposes in the Commission. So significant are these powers that the Supreme Court in *McMahon* based its holding in part upon both their presence and breadth. The Court described the powers as including both the expansive power to ensure the adequacy of arbitration procedures used by the SROs by monitoring the procedures' consistency with the requirements of the Exchange Act,[103] and the power to "abrogate, add to, and delete from" any SRO rule if the Commission finds such changes necessary or appropriate to further the Act's objectives.[104]

The SEC has invoked its broad powers from time to time in the issuance of rules and policy statements. Notably, notwithstanding the deference usually accorded the industry, some of the Commission's important initiatives prior to *McMahon* reflected a degree of cautiousness toward arbitration, which remains the industry's preferred dispute resolution device.

Rule 15c2-2,[105] for example, reflected the SEC's concern that cus-

---

means a substantial degree of *self*-regulation, properly supervised by government.

Id. (footnote omitted) (emphasis in original) (quoting S. REP. No. 1455, 75th Cong., 2d Sess. 3 (1938) and H.R. REP. No. 2307, 75th Cong., 3d Sess. 4 (1938)). The legislative history of the 1975 amendments to the Exchange Act states, in relevant part, as follows:

> Industry organizations, *i.e.*, the exchanges and the NASD, are delegated governmental power in order to enforce, at their own initiative, compliance by members of the industry with both the legal requirements laid down in the Exchange Act and ethical standards going beyond those requirements.
>
> The SEC is charged with supervising the exercise of this self-regulatory power in order to assure that it is used effectively to fulfill the responsibilities assigned to the self-regulatory agencies, and that it is not used in a manner inimical to the public interest or unfair to private interests.

S. REP. No. 75, 94th Cong., 1st Sess. 23, *reprinted in* 1975 U.S. CODE CONG. & ADMIN. NEWS 179, 201.

103. Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 234 (1987).

104. *Id.* at 233; *see also* Barnes, *NASD Disciplinary Proceedings*, 21 REV. SEC. & COMMODITIES REG. 161, 161 (1988).

> The Securities Exchange Act of 1934 (the Act) provides a comprehensive system of regulation of the securities industry through the self-regulatory organizations (SROs), the National Association of Securities Dealers, Inc. (NASD), and the stock exchanges. Indeed, beginning with the Maloney Act [Pub. L. No. 75-719, 52 Stat. 1070 (1938) (codified as amended at 15 U.S.C. § 780(c)(2), (3) (1988))], SROs were delegated wide-ranging rulemaking and regulatory authority, but with broad oversight authority and responsibility vested in the Securities and Exchange Commission (SEC). This reliance on supervised self-regulation was reaffirmed and strengthened when the Act was extensively amended in 1975. Those amendments gave an even greater oversight role to the SEC.

Id. (footnotes omitted); *see also* S. REP. No. 75, *supra* note 102, at 23, *reprinted in* 1975 U.S. CODE CONG. & ADMIN. NEWS at 201 (stating that "[t]he self-regulatory organizations exercise authority subject to SEC oversight . . . [having] no authority to regulate independently of the SEC's control"). For a general discussion of the SEC's overall authority to regulate the securities markets, see L. LOSS, *supra* note 102, at 667-733.

105. 17 C.F.R. § 240.15c2-2 (1988); *see also* Exchange Act Release No. 20,397 [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,452, at 86,356 (Nov. 18, 1983). Rule 15c2-2 was

tomers were being urged to accept arbitration clauses in brokerage contracts without being told that such clauses were "not enforceable with respect to claims arising under the federal securities laws."[106] Under this rule, a broker-dealer's and customer's entry into an arbitration agreement that failed to disclose the nonenforceability of such agreements in the context of federal securities law claims constituted a "fraudulent, manipulative or deceptive act."[107]

Nevertheless, the SEC changed directions completely in *McMahon*, in which it supported the securities industry's arguments that arbitration clauses should be accorded a broad scope of applicability.[108] In-

---

proposed in Exchange Act Release No. 19,813 [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,356, at 85,996 (May 26, 1983) (requiring that brokerage agreements must contain "adequate disclosure that [arbitration] clauses are not enforceable with respect to claims arising under the federal securities laws"). Rule 15c2-2 provided in relevant part:

> It shall be a fraudulent, manipulative or deceptive act or practice for a broker or dealer to enter into an agreement with any public customer which purports to bind the customer to the arbitration of future disputes between them arising under the federal securities laws, or to have in effect such an agreement, pursuant to which it effects transactions with or for a customer.

17 C.F.R. § 240.15c2-2 (1988). As a result of Rule 15c2-2, arbitration clauses generally contained prefatory language similar to the following: "ARBITRATION. It is understood that the following agreement to arbitrate does not constitute a waiver of the right to seek a judicial forum where such a waiver would be void under the federal securities laws." *See supra* note 12.

106. Exchange Act Release No. 19,813, *supra* note 105, at 85,966-67. In this release, the Commission explained that its somewhat more stringent position reflected not a disenchantment with arbitration but a strong concern with industry practices that tended to compromise investor protection:

> This action is consistent with the Commission's strong endorsement of fairly administered arbitration procedures as the most cost effective means of resolving certain disputes between broker-dealers and their customers.
>
> . . . .
>
> . . . Nevertheless, the Commission is concerned with a widespread industry practice which conflicts with legislative history, a thirty-year line of case law, and Commission releases.

Id. Strongly implied here was the Commission's view that *Wilko* applied to Securities Act and Exchange Act claims alike.

107. 17 C.F.R. § 240.15c2-2 (1988). In adopting this rule, the Commission clearly seemed to accept the view that *Wilko* applied to all federal securities law claims:

> *Wilko v. Swan* and subsequent cases have held that Congress had determined that public customers should have available the special protection of the federal courts for the resolution of disputes arising under the *federal securities laws*, and that under the anti-waiver provisions of *those laws*, that protection may not be waived in advance by contract of the parties.

Exchange Act Release No. 20,397, *supra* note 105, at 86,357 (citation omitted) (emphasis added); *see also* Klein & Harkins, *supra* note 99, at 198. In *McMahon*, however, the Court noted the SEC's position that promulgation of Rule 15c2-2, along with statements implying that *Wilko* applied to all federal securities act claims, was "premised on the Commission's assumption, based on court of appeals decisions following *Wilko*, that agreements to arbitrate Rule 10b-5 claims were not, in fact, arbitrable." *McMahon*, 482 U.S. at 234 n.3 (citing Brief for Securities and Exchange Commission as Amicus Curiae at 18 n.13).

108. Justice Harry Blackmun's concurrence and dissent in *McMahon* makes note of "the Securities and Exchange Commission's *newly adopted position* that arbitration procedures in the

deed, after the *McMahon* decision, the SEC rescinded Rule 15c2-2, stating that "the Court's reasoning [in *McMahon*] raised questions regarding the continuing vitality of . . . [the *Wilko*] decision . . . [and] the Commission believes that Rule 15c2-2 is no longer appropriate or accurate and, accordingly, should be rescinded."[109]

Thus, the SEC shifted from a broad interpretation of *Wilko* to an equally broad—and perhaps equally questionable—interpretation of *McMahon*. With its action, the SEC implied, particularly through its rescission of Rule 15c2-2, that *McMahon* overruled *Wilko*. At the time of the rescission, however, it was not absolutely clear that *McMahon* accomplished this task.[110] Indeed, the conclusion that the *McMahon* holding left *Wilko* intact as to section 12(2) Securities Act claims finds support in the following language from *McMahon*: "*While stare decisis concerns may counsel against upsetting Wilko's contrary conclusion under the Securities Act* [regarding the suitability of arbitration as a vehicle for vindicating investors' rights under that statute], *we refuse to extend Wilko's reasoning to the Exchange Act* in light of these intervening regulatory developments."[111]

Therefore, it was at least possible after *McMahon* that Securities Act claims remained nonarbitrable. This potentiality, combined with the rescission of Rule 15c2-2, meant that investors might face the same problems that the rule sought to solve. They could consent to, and proceed with, the arbitration process, quite unaware that some claims directed against brokerage firms may (or, more properly, must) be asserted in court and that court jurisdiction is not abrogated by the existence of an arbitration clause. Further, the confidence of these investors' in the integrity of the capital markets could be adversely affected by fears that their rights have been relegated, by both the Supreme Court and the SEC, to biased, industry controlled tribunals for justice.[112]

---

securities industry and the Commission's oversight of the self-regulatory organizations (SROs) have improved greatly since *Wilko* was decided." *McMahon*, 482 U.S. at 243 (Blackmun, J., dissenting) (emphasis added).

109. Exchange Act Release No. 25,034 [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,163, at 88,886 (Oct. 15, 1987).

110. *See* Klein & Harkins, *supra* note 99, at 196. The Supreme Court addressed this issue in *Rodriguez*. *See* Rodriguez de Quijas v. Shearson/American Express, Inc., 109 S. Ct. 1917 (1989); *supra* notes 84-96. *Rodriguez* resolved a split in the circuits. *Compare* Rodriguez De Quijas v. Shearson/Lehman Bros., Inc., 845 F.2d 1296 (5th Cir. 1988) (stating that "*McMahon* completely undermined *Wilko*"), *aff'd*, 109 S. Ct. 1917 (1989) *and* Peterson v. Shearson/American Express, Inc., 849 F.2d 464 (10th Cir. 1988) *with* Chang v. Lin 824 F.2d 219 (2d Cir. 1987) (*Wilko* remains good law in absence of express overruling by the Supreme Court) *and* Osterneck v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 841 F.2d 508 (3d Cir. 1988).

111. *McMahon*, 482 U.S. at 234 (emphasis added).

112. *See* Klein & Harkins, *supra* note 99, at 198-99 (noting that in the past the SEC has

Subsequent developments, however, may mitigate these problems. First, the *Rodriguez* holding obviated all confusion about available forums by clarifying that no claims under any of the securities laws are excluded from arbitration and reserved for exclusive jurisdiction in the courts.[113] Second, immediately after the *McMahon* decision, the SEC, armed with the results of an in-depth study of SRO arbitration procedures, began a major process to reform those procedures.[114] Choosing to conduct this process through SICA, the Commission set forth fifteen recommendations "designed to provide reasonable assurance of the procedural fairness of SRO-sponsored arbitration."[115] Additionally, the Commission has requested that the SROs "review the issues raised by the current use of mandatory predispute arbitration agreements by your member firms."[116] Study and debate have proceeded accordingly, with several proposals emerging for consideration.[117] On May 10, 1989, the SEC approved proposals submitted by the New York Stock Exchange, Inc. (NYSE), the National Association of Securities Dealers, Inc. (NASD), and the American Stock Exchange, Inc. (AMEX).[118]

"recogni[zed] . . . that effectively forcing investors to arbitrate their disputes might reinforce the investors' 'doubt [as to] the impartiality of officials associated with self-regulatory organizations and . . . hesitat[ion] to use the arbitration facilities' "); *see also* Exchange Act Release No. 15,984 [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,121, at 81,974, 81, 978 (June 26, 1979). Release No. 15,984 states:

> If broker dealers do not provide adequate disclosure about the limited enforceability of predispute arbitration agreements, or misrepresent the meaning of the arbitration clause in the context of a dispute, investors may be effectively deprived of any right they may have to choose an alternative forum at the time a dispute arises.

Id.

113. *Rodriguez*, 109 S. Ct. at 1920. What the holding did for overall investor confidence in the dispute resolution process, however, is another matter. Given the complaints from some that arbitration is biased against investors after *McMahon*, the *Rodriguez* holding can only have strengthened those views. *See, e.g.*, Quinn, *supra* note 10.

114. *See Arbitration Reform Hearings*, *supra* note 6, at 3 (statement of David S. Ruder, SEC Chairman) (referring to a letter dated Sept. 10, 1987, from Richard G. Ketchum, Director of the SEC Division of Market Regulation, to all SICA members).

115. *Id.* Generally, the recommendations addressed the areas of arbitrator conflicts of interest and overall ethicality, arbitrator competence, discovery procedures, public disclosure of pertinent award and hearing information, claimant education and prerogative to go to the American Arbitration Association (AAA), broker discipline, and rules for large cases.

116. Letter from Chairman David S. Ruder to all SROs and all SICA members (July 8, 1988).

117. The proposals submitted on these issues by the National Association of Securities Dealers, Inc. and the New York Stock Exchange, Inc. are the most significant and encompassing proposals and therefore will be the focus of this Article. In general, these proposals are developed on a cooperative basis through SICA, and then adopted, with relatively little if any variation, by the SROs.

118. *See* Exchange Act Release No. 26,805, *supra* note 21, at 80,099.

C. Conclusion on the Development of Securities Arbitration

Various developments have thrust securities arbitration to the forefront as the primary path for resolution of disputes between customers and their brokers and dealers. These developments repose significant prerogative in the SROs to make and enforce the procedures for effectuating this process, subject to SEC oversight. This Article now will address some crucial issues regarding arbitration procedures and their administration.

III. Improvement of Arbitration Procedures and Their Administration

A. Initial Disclosure and the Investor's Right to Choose

Two central and interrelated problems in securities arbitration are the investor's awareness of the presence and effect of arbitration clauses in brokerage agreements and the investor's right to choose whether to accept or reject such clauses. Critics of arbitration often have observed that preliminary dealings between prospective investors and broker-dealers in the past never provided for full and emphatic disclosure regarding the means of resolving disputes or the choice of those means.[119] Thus predispute arbitration clauses, which provide for waiver of an investor's right to pursue court remedies for violations of the brokerage agreement, usually existed quite inconspicuously amidst the agreement's other terms, unexplained by the presiding registered representative. Only later did the existence and significance of the clause become clear, perhaps at the time of the dispute, or in a motion to dismiss an investor's court action in favor of arbitration pursuant to the arbitration clause.[120] Proposed solutions to this problem have run the gamut from requirements of prominent disclosure of the clause and its effect to legal prohibitions of mandatory predispute arbitration clauses as conditions precedent to effecting trades in the brokerage account.

---

119. *See Arbitration Reform Hearings, supra* note 6, at 486 (statement of David S. Ruder, SEC Chairman). Chairman Ruder, not even considered a critic of arbitration, notes that "it is apparent that many customers are not provided with clear and informative disclosure of either the existence or meaning of predispute arbitration clauses." *Id.* The new rules address this problem. *See infra* notes 146-50 and accompanying text.

120. For a typical example of the point at which a brokerage firm makes its most noticeable statement about the presence and effect of the arbitration clause, see *McMahon*, 482 U.S. at 222-23. Once a claim is threatened or actually filed in court, the firm's self-interest is served best, of course, by asserting the clause.

1. Legal Proscriptions of Mandatory Predispute Arbitration Clauses

One of the investor protection approaches often proposed in securities arbitration debates would make it illegal to require mandatory predispute arbitration clauses in brokerage agreements as a condition precedent to trading under such agreements and requiring disclosure as to the nature and implications of a prospective customer's choices. Perhaps the clearest expression of the rationale for such a measure came from Michael J. Connolly, Secretary of State of the Commonwealth of Massachusetts, announcing the filing of state regulations directly on point.[121] Specifically, the Massachusetts regulations required that a broker disclose the legal implication of an arbitration clause so that customers signing the agreement could understand the full ramifications of giving up their right to have their claims heard in court.[122] The regulations also mandated that prior to the time a contract is signed between an investor and a broker, the broker negotiate to do business even if the customer chooses not to sign the arbitration agreement. Without such protection for small investors, the vastly superior economic power of brokers might force small investors to accept an arbitration clause or forfeit the opportunity to invest.[123] Connolly added that "[t]hese regulations not only provide investors with a choice regarding arbitration agreements, but . . . open[] up the dispute resolution process," and that "[i]nvestor confidence in a fair and open system is vital to a healthy investment economy."[124]

Even before they became effective, the Massachusetts regulations were overturned in litigation brought by members of the securities industry. A Massachusetts federal district court, in *Securities Industry Association v. Connolly*,[125] took its lead from *McMahon* and other recent cases favoring enforceability of arbitration agreements. The court held that the regulations violated the supremacy clause of the United States Constitution because they were preempted by the FAA.[126] The court concluded that the regulations did not merely supplement state law concerning matters "collateral to the validity and enforceability of

121. *See* MASS. REGS. CODE tit. 950, § 12.204(a)(2)((G)(1)(a)-(c) (1988) (statement of Secretary of State Michael Joseph Connolly); *see also Massachusetts to Be First to Ban Forced Arbitration*, PR Newswire, Sept. 21, 1988 (stating that the North American Securities Administrators Association reported that (1) 16 states were ready to follow Massachusetts' lead in enacting such regulations, and (2) about 9 out of 10 options and margin accounts were covered by mandatory arbitration agreements, as were 39% (about 5 million) of the cash accounts held by individuals).

122. *See* MASS. REG. CODE tit. 950, § 12.204(a)(2)(G) (1)(a)-(c) (1988).

123. *Id.* (statement of Secretary of State Michael Joseph Connolly).

124. *Id.* (statement of Secretary of State Michael Joseph Connolly).

125. 703 F. Supp. 146 (D. Mass. 1988), *aff'd*, 883 F.2d 1114 (1st Cir. 1989), *cert. denied*, 110 S. Ct. 861 (1990).

126. *Id.* at 161.

arbitration agreements."[127] Rather, the regulations went "to the heart of the process of forming contracts to arbitrate," and "single[d] out arbitration agreements for more demanding standards than are imposed by the general law of contracts in Massachusetts."[128]

In determining " 'whether Congress [in enacting the Arbitration Act] (expressly) did or (impliedly) meant to displace state law or state law concepts,' "[129] the court noted that "[a]s a matter of logic, [the] analysis . . . focuses on whether the state regulations 'single out arbitration agreements' for special treatment"[130] and thus "eviscerate" the Act's purpose of placing arbitration agreements on the same footing as other contracts.[131] "Because the . . . unique Massachusetts securities arbitration regulations impose conditions on the formation and execution of arbitration agreements [that] are not part of the generally applicable contract law of Massachusetts, they cannot be given effect under the Federal Arbitration Act."[132] Nor do the various savings clauses in the federal securities laws, which permit concurrent state and federal regulation of the securities business, "provide a 'contrary Congressional command' permitting state Blue Sky regulators to establish special conditions applicable to arbitration contracts in derogation of the directions of the Federal Arbitration Act."[133]

On appeal, the United States Court of Appeals for the First Circuit affirmed the district court's holding.[134] The First Circuit essentially adopted the district court's reasoning based on *McMahon* and its contributing predecessors, and buttressed that reasoning with references to the *Rodriguez* holding. The court noted that "just this year, in the course of overruling *Wilko v. Swan* . . . the [Supreme] Court again emphasized 'the strong language' of the FAA and noted the heavy burden borne by opponents of the arbitral alternative."[135]

Observing that the language of the Arbitration Act "sweeps broadly and brooks little reservation," and that therefore "the Court has almost always given the Act a reading which is both broad and deep,"[136] the appellate court even attempted to reconcile the Supreme Court's hold-

---

127. *Id.* at 147.

128. *Id.*

129. *Id.* at 150 (quoting Palmer v. Liggett Group, Inc., 825 F.2d 620, 625-26 (1st Cir. 1987)).

130. *Id.* at 151 (quoting Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, 723 F.2d 155, 158 (1st Cir. 1983), *aff'd in part, rev'd in part*, 473 U.S. 614 (1985)).

131. *Id.*

132. *Id.* at 153.

133. *Id.* at 154 (quoting Kroog v. Mait, 712 F.2d 1148, 1153 (7th Cir. 1983), *cert. denied*, 465 U.S. 1007 (1984)).

134. *Connolly*, 883 F.2d at 114.

135. *Id.* at 1118 (citations omitted).

136. *Id.* at 1118-19.

ing in *Volt* with the *McMahon-Rodriguez* line of High Court decisions. The First Circuit reasoned that the *Volt* Court merely ruled that interpreting a choice of law clause to apply state rules for conducting arbitration does not offend any rule of liberal construction or any policy embodied in the FAA, particularly when the state rules are designed to encourage use of arbitration.[137] Because the choice of law provision in *Volt* did not impinge on the validity or enforceability of an arbitral contract, the California regulation filled a gap in the FAA.[138] According to the First Circuit, however, the Massachusetts regulations undermined the presumption of validity that the Arbitration Act confers on arbitration contracts generally.[139] Based on this reasoning, the First Circuit decided that because the Massachusetts regulations treated standard form predispute arbitration agreements in the securities industry more severely than other standard form contracts under Massachusetts law, and because the policies underlying the Regulations and their method of enforcement conflicted with the national policy favoring arbitration, the state scheme is preempted by the federal plan.[140]

Thus, to the extent *Connolly* is affirmed by the Supreme Court, state action in this arena may be precluded, or at least, severely restricted.[141] Although the case is expected eventually to be heard by the Supreme Court, *McMahon* and *Rodriguez* augur strongly in favor of the High Court sustaining the lower courts' holdings. This expectation results from the emphasis those two opinions place on the federal policy promoting enforceability of arbitration under the FAA.[142] Only the *Volt*

---

137. *Id.* at 1119 n.3. The court specifically held:

> *Volt* is not to the contrary. There, the Court ruled that "interpreting a choice-of-law clause to make applicable state rules governing the conduct of arbitration—rules which are manifestly designed to encourage resort to the arbitral process—simply does not offend the rule of liberal construction . . . nor does it offend any other policy embodied in the FAA." . . . [T]he choice-of-law provision in *Volt* did not impinge on the validity or enforceability of the arbitral contract. The California regulation filled in an interstice in the FAA, whereas the Regulations here at issue plainly undermine the presumption of validity that the Act meant to confer on arbitration contracts generally.

Id. (citations omitted) (quoting Volt Information Sciences, Inc. v. Board of Trustees, 109 S. Ct. 1248, 1254 (1989)).

138. *Id.*

139. *Id.*

140. *Id.* at 1124.

141. In the wake of the *Connolly* opinions, Massachusetts officials now apparently are looking to the federal arena for action. *See Massachusetts May Seek Federal Action Against Securities Arbitration*, McGraw-Hill News, Sept. 1, 1989. Martin Meehan, Massachusetts Deputy Secretary of State, has commented tbat the State will "push for action at the federal level" to prevent brokerage firms from pressuring customers to give up their rights to sue, and that the State remains "committed to the notion that investors ought to have the right to sue their brokers. . . . We feel Congress needs to act." *Id.*

142. 109 S. Ct. 1917, 1920 (1989); Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 225-26, 232 (1987). Early in the *Connolly* litigation an attorney for the securities industry has

holding would appear to articulate even remotely any basis upon which the Massachusetts regulation could be upheld, and in this regard, the First Circuit's attempt at harmonizing that case with the Supreme Court's more affirmatively proarbitration decisions certainly is convenient and could be persuasive.[143]

2. Disclosure As a Protective Device

Should the Supreme Court uphold the decisions of the lower courts in *Connolly*, any action prohibiting mandatory predispute arbitration clauses may have to come from the SEC or Congress. At present, however, the only active proposals or enactments at the federal level focus, not upon the prohibition alternative, but upon disclosure of the terms and implications of those clauses.[144] In congressional testimony, the Chairman of the SEC explained the problem and the need surrounding the disclosure issue: "[I]t is apparent that many customers are not provided with clear and informative disclosure of either the existence or meaning of predispute arbitration clauses. The SROs should examine ways to improve disclosure at the time of account opening."[145]

The SROs have responded to the various expressions of concern about the quality of initial disclosure with improvements in the rules relating to the use of predispute arbitration agreements. Generally, under the rules the arbitration clause in a brokerage contract must be

---

expressed orally to the Author the opinion that whatever the outcome at the circuit court level, a further appeal probably will be sought by the losing party. On November 29, 1989, the State of Massachusetts filed a formal petition for certiorari in *Connolly*, seeking to have the United States Supreme Court review the case. (No. 89-894). Additionally, on January 22, 1990, the Supreme Court invited the Solicitor General of the United States to file a brief expressing the views of the United States concerning the holding of the First Circuit in *Connolly*. *See* 22 Sec. Reg. & Law Rept., No. 4, p. 134 (Jan. 26, 1990); *Court Seeks U.S. View on Arbitration*, Wash. Post, Jan. 23, 1990, at D5, col. 1.

143. *See Connolly*, 883 F.2d at 1119 n.3; *see also supra* note 137.

144. *See supra* note 141. For examples of the disclosure provisions of the new SEC rules, see *infra* notes 160-65 and accompanying text. As to congressional action, H.R. 4960, 100th Cong., 2d Sess. (1988) died in Committee during the last Congress. *See* 2 Cong. Index (CCH) 35,106 (100th Cong.). There have been signs, however, of possible legislative action. In a letter dated Feb. 5, 1990, Representatives John Dingell (D-Mich.), Chairperson of the House Energy and Commerce Committee, and Edward Markey (D-Mass.), Chairperson of the House Subcommittee on Telecommunications and Finance, asked the Government Accounting Office (GAO) to undertake a comprehensive review of SRO arbitration. Representatives Dingell and Markey observed in the letter that "[s]ecurities arbitration continues to be a thorn in the side of the small investor, who sees it as unfair and coercive." Their hope is that the GAO study "will provide us with a clear assessment of the effects on the individual investor . . . and what if anything Congress can do to address the continuing concerns of those investors." *See* Hinden, *GAO Asked to Investigate Securities Arbitration Issues*, Wash. Post, Feb. 7, 1990, at D1, col. 1; Wall Street Letter, Institutional Investor, Feb. 12, 1990, at 2.

145. *Arbitration Reform Hearings*, *supra* note 6, at 486 (statement of David S. Ruder, SEC Chairman).

highlighted and must contain highlighted prefatory language, printed in outline form, stating the following:

> (a) Arbitration is final and binding on the parties.
> (b) The parties are waiving their right to seek remedies in court, including the right to jury trial.
> (c) Prearbitration discovery is generally more limited than and different from court proceedings.
> (d) The arbitrators' award is not required to include factual findings or legal reasoning and any party's right to appeal or to seek modification of rulings by the arbitrators is strictly limited.
> (e) The panel of arbitrators will typically include a minority of arbitrators who were or are affiliated with the securities industry.[146]

The rules impose further requirements. These provisions mandate that: there be a highlighted statement immediately preceding the signature line that the agreement contains a predispute arbitration clause;[147] the customer receive, and acknowledge receipt of, a copy of the clause;[148] there not be any condition in the agreement limiting or contradicting any SRO rules, limiting a party's right to file a claim, or limiting an arbitrator's ability to make an award;[149] and those rules shall only apply to new agreements.[150]

3. Analysis of Mandatory Arbitration—Striking the Proper Balance

Adoption of the new disclosure rules was proper and will benefit investors and the capital markets. The rules are calculated to provide clear and fair warning to prospective investors about the dispute resolu-

---

146. N.Y. STOCK EXCH., INC., ARBITRATION RULES, art. XI, Rule 637(1)(a)-(e), *reprinted in* 2 N.Y.S.E. Guide (CCH) ¶ 2637 (May 10, 1989) [hereinafter NYSE ARBITRATION RULES]; Amendment to National Association of Securities Dealers (NASD) Rules of Fair Practice, art. III, § 21(f)(1)(a)-(e) (note that this rule is placed in the part of the NASD Rules dealing with broker-dealer conduct and practice, whereas the other new NASD rules appear in the NASD Code of Arbitration Procedure); AMERICAN STOCK EXCH., INC., OFFICE RULES, Rule 427(a)(1)-(5), *reprinted in* 2 Am. Stock Ex. Guide (CCH) ¶ 9447 (May 10, 1989) (also appearing in a section different from the main body of arbitration rules). *See generally* Exchange Act Release No. 26,805, *supra* note 21, at 80-099-81,108 (approving proposed new rules).

147. *See, e.g.*, NYSE ARBITRATION RULES, *supra* note 146, Rule 627 (2). The Rule states that: "Immediately preceding the signature line, there shall be a statement which shall be highlighted that the agreement contains a pre-dispute arbitration clause. The statement shall also indicate at what page and paragraph the clause is located." *Id.*

148. *See, e.g., id.* Rule 637(3). The Rule specifies: "A copy of the agreement containing any such clause shall be given to the customer who shall acknowledge receipt thereof on the agreement or on a separate document." *Id.*

149. *See, e.g., id.* Rule 637(4). The Rule stipulates that: "No agreement shall include any condition which limits or contradicts the rules of any self-regulatory organization or limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award." *Id.*

150. *See, e.g., id.* Rule 637(5), which states that: "The requirements of this section shall apply only to new agreements signed by an existing or new customer of a member or member organization after September 7, 1989." *Id.*

tion device they would be electing at the time they enter into brokerage agreements, and correspondingly, about what waivers of choice to a forum would apply.[151] In developing and proposing these rules, the SROs responded to past circumstances that established the need for greater investor protection in the pre-entry phase of the brokerage engagement.[152] By doing so, the SROs seized the opportunity to express emphatically the industry's willingness to operate in a fair, impartial dispute resolution environment.

By proposing these significant protections in the form of prominent disclosure requirements, however, the industry may have sought to avoid adoption of a more stringent measure, such as a proscription against mandatory arbitration agreements. Having now avoided such a stricture, and with the new rules now in effect, certain critical issues arise under this new regulatory pattern. First, the sufficiency of the disclosure rules must remain a matter of substantial concern until experience has demonstrated that they are satisfactory.[153] Second, with no specific regulatory guidance or requirements with respect to mandatory predispute arbitration agreements, open questions remain as to how—and even whether—the industry will seek to establish an equitable balance between the competing interests: investors' prerogatives to choose the best forum in which to vindicate their rights and a brokerage firm's prerogative to condition its services on such mandatory agreements in order to secure reasonable risk minimization and economy for itself.

a. The Problem

SEC Chairman David S. Ruder has noted that mandatory arbitration clauses are imposed most frequently in margin and option trading agreements, and in doing so has described the perspectives of both broker-dealer firms and investors in relation to the aforementioned balanc-

---

151. *See supra* notes 29-36, 67-69 and accompanying text.

152. For example, the NYSE proposal was submitted on Octoher 14, 1988, just over one year after the September 10, 1987 letter from SEC Director of Market Regulation Richard Ketchum, and about three months after Chairman Ruder's July 8, 1988 letter. *See supra* notes 115-17.

153. *See* Karmel, *Arbitration and the Demise of* Wilko v. Swan, N.Y.L.J., June 15, 1989, at 3, col. 1. Roherta S. Karmel, a former SEC commissioner and former public director of the NYSE, states:

> Whether SEC oversight will give SRO maintained arbitration facilities greater credibility than they have previously enjoyed remains to be seen. . . .
>
> . . . .
>
> Perhaps the very controversy over securities industry arbitration, which the plaintiffs' bar is likely to keep alive, will prove its salvation. The continued scrutiny that it is likely to receive should prompt SROs and arbitrators to give investors a fair break.

Id. at 4, col. 4.

ing question.[154] Essentially, broker-dealers argue that margin accounts[155] put them at greater financial risk, that options[156] and margin accounts will be more technically complicated than standard cash accounts, and that such accounts are more likely to produce litigation.[157] From the broker-dealer perspective, arbitration provides a measure of risk management, an adjudicating body more highly trained in securities matters, and a less expensive forum for frequent dispute resolution.[158] Advocates of customer choice, on the other hand, focus on the fiduciary responsibility and customer suitability issues that margin and options accounts may generate, issues that may be more appropriate for court adjudication.[159]

The debate over mandatory predispute arbitration clauses should not necessarily cease with the enactment of the new disclosure rules. Because a central objective of the securities laws is investor protection—including the right to choose an effective forum—every effort should be made to ensure such protection to the greatest degree, in letter and in spirit, while minimizing any associated burdens on the industry.[160] This emphasis not only may require more than disclosure, but

---

154. *Arbitration Reform Hearings, supra* note 6, at 484 (statement of David S. Ruder, SEC Chairman).

155. *See generally* R. HAMILTON, FUNDAMENTALS OF MODERN BUSINESS § 18.16, at 446 (1989).

> A margin transaction simply involves borrowing money from your broker to enable you to buy more shares of marketable securities. By obtaining such a loan, an investor may make a larger investment than he or she could have without the loan. [T]he loan is secured by a lien of the securities purchased. . . .

Id.; *see also* A. PESSIN, FUNDAMENTALS OF THE SECURITIES INDUSTRY 302-04 (1985).

156. *See generally* M. THOMSETT, INVESTMENT AND SECURITIES DICTIONARY 195 (1986) (stating that an option is "a contract allowing the holder (buyer) to purchase or sell 100 shares of a security, . . . [that] ha[s] a finite life, and become[s] worthless following an expiration date").

157. *Arbitration Reform Hearings, supra* note 6, at 484-85.

158. *Id.*

159. *Arbitration Reform Hearings, supra* note 6, at 484-85 (statement of David S. Ruder, SEC Chairman).

160. The SEC did not put pressure on the SROs specifically to adopt prohibitions on mandatory arbitration agreements. The Commission's July 8, 1988 letter to the SROs noted: "In the Commission's view, for the brokerage industry generally to condition access to its services on the execution of a mandatory arbitration clause, as appears to be the case at least for margin and option accounts, raises serious policy issues." Letter from Chairman David S. Ruder to all SROs and all SICA members (July 8, 1988).

Rather than impose specific rules, however, the Commission requested that the SROs "review the issues raised by the current use of mandatory predispute arbitration agreements" and "report back . . . on your conclusions." *Id.* The SROs appear to have concluded that prohibition of such agreements was unnecessary, or undesirable, and that any problems could be resolved through more prominent disclosures in the brokerage agreement. The SEC's initiative appears to have emanated from the various political pressures surrounding this issue, as well as a study conducted of 65 broker-dealers that account for 90% of all customer trading accounts in the United States. The study found that 96% of the margin accounts, 95% of the options accounts, and 39% of the cash accounts at the firms studied had mandatory clauses. This result prompted Chairman Ruder to observe that "[t]he reported trend toward the use of mandatory predispute clauses for cash ac-

may eliminate several less affirmative courses that fall short of a direct prohibition on mandatory arbitration clauses. For example, a free-market oriented approach otherwise might be proposed, wherein consumer expressions of disapproval would encourage competition among firms, thus creating a market for brokerage agreements without mandatory arbitration clauses, or discouraging the use of such clauses altogether. The SEC appeared to suggest such an approach when it adopted the new arbitration rules: "Under the circumstances presented, the Commission is reluctant to dictate the terms of a fully disclosed agreement between a broker-dealer and a customer. Investors currently have access to basic brokerage services without agreeing to pursue any future disputes through arbitration, rather than through the courts."[161]

These observations, however, are of little or no relevance, because even the Commission "recognizes that investors do not have such access with respect to margin and options accounts"—the types of accounts on which mandatory arbitration is usually imposed.[162] The Commission observes, however, "that with respect to margin accounts, the firms' separate lending relationship with the customer may increase the desirability of agreeing in advance that disputes will be resolved through arbitration."[163] Additionally, the Commission believes that the combination of disclosure and free-market forces could obviate any real or perceived threat to investor protection because "the improved disclosure provided in the rules will . . . alert investors as to the consequences of signing predispute arbitration clauses."[164] Should "a class of investors emerge who object to predispute arbitration agreements," the Commission is optimistic that competitive forces will result in some firms offering margin or options accounts without such agreements.[165]

The problem with the Commission's speculations is the status of the typical small investor. It is widely accepted that this category of investor is at the mercy of considerably more powerful economic and psychological forces in negotiating the terms of a brokerage agreement.[166] Whether or not this belief is true, these allegations constantly

---

counts was particularly disturbing." *Arbitration Reform Hearings, supra* note 6, at 484 (statement of David S. Ruder, SEC Chairman). The Commission apparently has no intent to take action itself on this issue; it has determined to "look for guidance and information from the" SROs, but expects "strong assurances that customer choice, at least in cash accounts, will be maintained." *Id.* at 484-85.

161. Exchange Act Release No. 26,805, *supra* note 21, at 80,113

162. *Id.*

163. *Id.*

164. *Id.*

165. *Id.*

166. *See supra* note 123 and accompanying text; *see also Arbitration Reform Hearings, supra* note 6, at 271-72 (statement of James C. Meyer, Pres., N. Am. Sec. Adm'rs Ass'n). James Meyer observed:

will be made, and the effect of failing to respond to them may be to diminish public confidence in the capital markets and in industry sponsored arbitration.[167] Additionally, even the practical effect of the current pressure from leaders in the legislative and regulatory arenas to reform the system may not suffice to maintain, on a permanent basis, the judicious approaches to the use of mandatory provisions that apparently now prevail.[168] Once reforms are in place, or with the introduction of a different regulatory philosophy, "business as usual" would be free to resume.[169]

On the other hand, to the extent arbitration is established as a forum of unquestionable integrity and effectiveness, the notion of unfettered choice of forum becomes more a rhetorical or political device than a matter of substance. If arbitration is truly a fair, impartial, efficient

---

> It has become increasingly clear that signing a predispute arbitration agreement is rapidly becoming a precondition for doing business. A customer who does not want to sign such a contract is not likely to get an account. Given the manner in which arbitration agreements are typically presented to investors, where there may be little or no disclosure, and the pressures placed upon them to sign, it is simply not realistic to conclude that these arbitration agreements are voluntary.

Id.

167. *See Arbitration Reform Hearings, supra* note 6, at 266 (statement of James C. Meyer, Pres., N. Am. Sec. Adm'rs Ass'n) (stating that "[a]rbitration reform would send a helpful signal to investors who feel that no longer is there a place for the 'little guy' in the capital markets"); *supra* notes 6 & 9.

168. The recent publicity and congressional attention directed at this matter apparently have encouraged many brokerage firms to cease requiring mandatory clauses in cash account agreements. *See Arbitration Reform Hearings, supra* note 6, at 484 (statement of David S. Ruder, SEC Chairman); *id.* at 461 (statement of Rep. Edward J. Markey) (noting that because "the possibility of legislation has become a reality, some firms which previously indicated an intention to incorporate arbitration clauses into cash accounts now disavow a 'present intent to do so' ").

169. For an example of the effect of regnlatory philosophy on the extent of enforcement and, thus, of investor protection, see Coll & Vise, *Chairman Tried to Cool Staff Regulatory Zeal*, Wash. Post, Feb. 6, 1989, at A1, col. 1 (discussing the regulatory approach of John Shad, former SEC Chairman, and the purported effects of that approach). Specifically, the article noted:

> Shad's actions reflected his desire to steer the SEC away from what he viewed as excessive interference in the daily business of Wall Street, part of his broad interest in freeing brokerage firms and the stock exchanges from what he felt was overregulation that restrained the nation's economy.
>
> . . . .
>
> The debate [between Shad and enforcement oriented staff at the SEC] had far-reaching implications: It raised a basic question about who was responsible for detecting and preventing fraud on Wall Street. The issue took on added significance toward the end of Shad's tenure at the SEC, when the biggest Wall Street corruption scandal in history erupted, focusing in large part on charges of fraud by employees in a branch office of Drexel Burnham Lambert Inc.

Id. at A1, col. 1, A17, col. 1. *Contra* Vise, *Beyond Crisis Management*, Wash. Post, Dec. 3, 1989, H1, col. 2, in which it is reported that SEC Chairman Richard C. Breeden takes a different approach: "His experience as the administration's quarterback of the savings and loan bailout legislation earlier this year reinforced his belief that free markets can function effectively *only with adequate government supervision and zealous enforcement.*" *Id.* at H4, col. 4 (emphasis added).

device, nothing should be lost by allowing mandatory arbitration clauses, especially in instances that limit unreasonable risk and expense to brokerage firms.

b. Guiding Principles

In view of the foregoing considerations, three fundamental principles emerge. First, the present endeavors to place arbitration above reproach must continue, always seeking the highest level of quality. Second, mandatory arbitration clauses must carry proper disclosure that they are a condition precedent to effecting trades under the brokerage agreement. Finally, such clauses must be allowed only to the extent they protect important interests of the brokerage firms and have a negligible adverse impact on investor protection.

These principles would provide protection to investors against inadvertently and unknowingly accepting such clauses to their detriment. Also, by confining such clauses only to the most justifiable situations, the industry would preserve and promote the crucial public perception that it itself seeks to be fair. Finally, if arbitration is indeed fair and effective, the problem simply should disappear.

c. Application of the Principles

(i) Who should be protected from mandatory arbitration clauses?

Because cash account agreements do not generate as high a risk for firms as margin accounts, they may be clear candidates for a preclusion against mandatory clauses.[170] This case, however, is the easy one; it is the options and margin accounts that pose the difficult questions.[171] In this regard, institutional and sophisticated investors are the most feasible category of candidates for not providing protections against mandatory clauses in options and margin trading agreements. Conversely, smaller, less-informed investors would appear to deserve most the benefit of a broader range of forum choices. The larger investor is conceivably more capable of understanding the nature of the overall agreement and probably occupies a stronger bargaining position; all of which implies a greater ability to fend for one's self.[172] Moreover, this

---

170. *See Arbitration Reform Hearings, supra* note 6, at 484 (statement of David S. Ruder, SEC Chairman). Chairman Ruder, in expressing the industry's rationale for using mandatory clauses, discusses only margin and options agreements, and even notes that "industry statements have been made suggesting that many industry members will not [now] require predispute arbitration clauses in cash account agreements." *Id.*

171. *Id.*

172. *See Arbitration Reform Hearings, supra* note 6, at 271 (statement of James C. Meyer, Pres., N. Am. Sec. Adm'rs Ass'n). Mr. Meyer stated:

Interestingly, Mr. Ketchum [SEC Market Regulation Division Director, in the staff study

type of trader is more likely to invest large sums, invoke sophisticated trading schemes, or both, and generate larger risks for the brokerage firm, the capital markets, and even the economy.[173]

Nevertheless, it could be argued that smaller investors, certainly those of the speculative stripe, generally create greater degrees and magnitudes of risk, especially in relation to their investments. They have fewer resources from which to pay in the event of big losses and are less sophisticated, impliedly making them more susceptible to mistakes in investment strategies. Therefore, the reasoning might proceed, brokerage firms should have the right to limit their potential risks through mandatory arbitration agreements. Mitigating this conclusion, however, is the concept of suitability. When a broker applies proper suitability standards, a smaller, less sophisticated investor only will be allowed to trade or speculate within certain risk parameters.[174]

Thus the burden could be placed on the suitability evaluation. The broker must conduct such an evaluation prior to entering each brokerage agreement and should keep it in mind in advising customers, both to serve the traditional function of limiting the nature of the invest-

---

of 65 top brokerage firms' practices with respect to mandatory arbitration clauses] noted that brokerage firms *are more flexible when it comes to some institutional investors*, and are often willing, when requested, to waive the predispute arbitration agreement for these institutional investors. This raises troubling questions about the unfair advantage and access enjoyed by large investors and denied to small investors.

Id. (emphasis in original).

173. R. HAMILTON, *supra* note 155, at 346.

Even though institutional investors view themselves as passive investors, their sheer size raises unique market problems. For example, if an institutional investor decides to exercise its Wall Street option and sell its shares, the block may be so large that only other institutional investors have the capacity to absorb the shares. Large institutional holdings may therefore increase the volatility of share prices since an independent decision by several large institutional investors to dispose of their shares may markedly depress shortrun prices because there is not enough demand to absorb the shares being dumped on the market.

Id.; *see also* REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS 41 (1988) [hereinafter BRADY REPORT] (commenting on "several important themes" surrounding the October 1987 stock market crash). The Brady Report summarized: "Fourth, much of the selling pressure was concentrated in the hands of surprisingly few institutions. A handful of large investors provided the impetus for the sharpness of the decline." *Id.*

174. "Suitability" refers to the fitness of a particular investment security for the particular investor to whom the investment is heing recommended and the duty of the broker to seek a reasonable match of the two—the "know your customer" rule. For example, the NASD RULES OF FAIR PRACTICE art. III, § 2 provides:

In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his security holdings and as to his financial situation and needs.

Id.; *see also* NYSE Rule 405. In pursuit of establishing suitability, a broker's registered representative will elicit information on a prospective investor's investment history—length of time, types of investments, etc.—salary and employment information, net worth, number of dependents, and other pertinent matters.

ment scheme to those types the investor can handle, and to limit some of the firm's risks associated with margin and options trading. Understandably, broker-dealers would balk at this notion and reason that the scope of permissible risk taking in carrying out an options or margin trading arrangement is, and must be, broader than the scope of risk taking within which a firm can operate without prescribing its own efficient, economical dispute resolution mechanism.[175] Perhaps they would be right, but the proposed arrangement certainly would create a closer link between the firm's risks and its duty of vigilance in determining which investors should be employing these more sophisticated and risky investment vehicles and strategies. Also, neither the substance of investor protection nor the public perception of its status would suffer under this proposed nexus; indeed, they would be enhanced.

Another argument in favor of mandatory arbitration clauses for small investors is that allowing small investors the option to go into court invokes the complicated, already overcrowded machinery of the judiciary—with all the attendant costs—in order to consider matters too technical for a judge or jury to handle.[176] At the outset, however, this concern would be reduced appreciably by the disincentives to small investors to go into court that are based in the fundamental reasons for arbitration: small investors are not likely to want to spend large sums and wait for years for a court decision on what is usually a small claim.[177] Therefore, fears of an avalanche of cases by small investors probably are misplaced. Additionally, and particularly when frivolous claims are asserted, dispositive motions and motions for fees and costs are available to broker-dealers.[178]

---

175. Brokers probably would argue that the brokerage and investment relationships necessarily entail providing investors with the latitude to take significant risks—and with the responsibility for losses flowing from accepting such risks—as long as those investors are fully informed, not misled, and have been placed generally in the right speculative arena. Under those circumstances, brokers might argue, firms and their registered representatives should not be required to serve as guarantors of the success of an investment device or strategy.

176. *See Arbitration Reform Hearings, supra* note 6, at 76 (statement of Theodore A. Krebsbach, Co-Head of Litigation Department, Shearson Lehman Hutton, Inc.). Mr. Krebsbach argued the *McMahon* case for Shearson before the Supreme Court. He states:

> The delay resulting from the congestion in the federal courts is not the only problem facing a potential litigant today. Even more significant is the cost of litigation, primarily resulting from abuses of a discovery process which was originally designed to ensure due process for all litigants.
>
> . . . .
>
> . . .[I]n many cases a plaintiff's recovery is greatly reduced, and oftentimes it does not equal the amount he has to pay his attorney in legal fees.

Id. at 76, 78.

177. *Id.*

178. *See* FED. R. CIV. P. 11 (motion for sanctions based on frivolous allegations, claims, and defenses); *id.* Rule 12(b) (motions to dismiss); *id.* Rule 12(c) (motion for judgment on the plead-

Similarly, contentions that courts are ill-suited to handle the complicated matters often presented in securities claims suffer from certain countervailing realities. First, there is the entire body of complicated business and financial matters that consistently find their way into the court system. Courts always have been and always will be adjudicating those matters and rendering opinions. Second, court rules such as Federal Rule of Civil Procedure 53 provide for the appointment of masters in special instances such as these, in which the issues are complicated and technical.[179] Thus, the use of the courts in disputes between broker-dealers and their customers does not necessarily place unreasonable burdens on brokerage firms or lessen the possibility of a just resolution of the conflict.

Finally, as this Article has alluded throughout, the basic notion of choice is a hallowed concept in a democratic society, especially as it relates to those with a disadvantage in terms of power or knowledge. This theme always will exist and must be considered, both because it is a legitimate value and because even its apparent abuse may have a fundamental, adverse effect on the integrity of the capital markets.[180] For this reason, as well as the others discussed above, the proposed scheme of prohibiting the use of mandatory predispute arbitration clauses under certain circumstances would be beneficial and should be adopted.

---

ings); *id.* Rule 50(a) (motion for directed verdict); *id.* Rule 56 (motion for summary judgment); *id.* Rule 54(d) (costs). It should be noted, however, that these provisions only may mitigate somewhat the time and costs of litigation. *See generally Arbitration Reform Hearings, supra* note 6, at 76 (statement of Theodore A. Krebsbach) (citing Kaufman, *The Public's Right to Speedier Justice*, N.Y. Times, Oct. 16, 1987, at A39, col. 2).

179. FED. R. CIV. P. 53 provides:

> Rule 53. Masters.
>
> (a) Appointment and Compensation. The court in which any action is pending may appoint a special master therein. As used in these rules the word "master" includes a referee, an auditor, an examiner, and an assessor. . . .
>
> (b) Reference. A reference to a master shall be the exception and not the rule. In actions to be tried by a jury, a reference shall be made only *when the issues are complicated*; in actions to be tried without a jury, save in matters of account and of difficult computation of damages, a reference shall be made only upon a showing that some exceptional condition requires it.

Id. (emphasis added).

180. *See Arbitration Reform Hearings, supra* note 6, at 46 (statement of Rep. Edward J. Markey). Representative Markey delivered a dramatic statement supporting the investor's right to choose: "Events in recent times have crushed public confidence. An investment world dominated by institutional trading, daylight trading and program trading is already a cold and uninviting landscape for individual investors. Do we really want to take away their day in court as well?" *Id.*

(ii) When arbitration is chosen or required, should nonindustry forums be a required option?

Now that the enforceability of valid arbitration agreements is virtually assured, and because these agreements are widely used, the logical question arises of whether arbitration before a nonindustry forum, or at least the possibility of choosing that option, enhances the integrity of securities arbitration. Many commentators believe such enhancement occurs, primarily because the arbitration process is not administered by the securities industry; thus neither the possibility of improper, proindustry bias nor the perception of one, will be likely to exist.[181]

Because relatively few brokerage firms are willing to include the AAA among the forum options in their arbitration agreements,[182] many customers have sought access through the "AMEX Window." Essentially, this strategy is employed by customers in instances when their brokerage firm is a member of the American Stock Exchange (AMEX). The idea is to claim a legal right to arbitrate before the purportedly fairer AAA—notwithstanding the fact that the arbitration clause in the brokerage agreement expressly lists only the AMEX and certain other SRO forums as choices—by relying on a construction of the AMEX constitution.[183]

---

181. *See* Quinn, *supra* note 10, at 43. This article further states:

> To resolve a dispute, choose the [American Arbitration Association]. In [the opinion of Robert Dyer, "a controversial and well-respected customer's attorney who prefers the AAA to the SROs," SECURITIES ARBITRATION 1989, *supra* note 8, at 11] *it's fairer to investors.* For an industry panel, take the National Association of Securities Dealers. Try to avoid the New York Stock Exchange's panel, especially in New York where [Dyer] says, "investors get hammered."

Id. (emphasis added); *see also* Dyer, *A Practitioner's Critique, Or Looking At Arbitration From The Customer's Viewpoint*, in SECURITIES ARBITRATION 1989, *supra* note 8, at 335-36. Dyer further states:

> For all practical purposes, the American Arbitration Association is the only independent forum. . . .
>
> . . . .
>
> . . . In any given case, an SRO panel may render a fair decision, awarding all the relief due under law. But all too often these SRO panels render compromise awards. On the other hand, AAA panels, when they find in favor of the customer, are more likely to will [sic] award (1) damages based on the well-managed account measure of damages, now recognized by the courts, (2) preaward interest, (3) attorney fees and (4) punitive damages where appropriate.

Id. (citations omitted); *see also* Poser, *Securities Arbitration And The Expert*, in 601 P.L.I, SECURITIES ARBITRATION 1988 683, 691 (corporate law and practice course handbook series for 1988) (stating that "the rules of the self-regulatory organizations should require that the arbitration clauses used by their member firms give investors the option of selecting . . . [a]rbitration using the facilities of the American Arbitration Association, in which the parties select mutually acceptable arbitrators from lists provided by the A.A.A.").

182. *See* Dyer, *supra* note 181, in SECURITIES ARBITRATION 1989, *supra* note 8, at 335 (observing that "[t]here seems to be no evidence that as a result of these new securities rules any major brokerage firms are giving their customers a choice of AAA").

183. *See id.* at 338-45; *see also* PaineWebber, Inc. v. Pitchford, [Current Binder] Fed. Sec. L.

A customer's argument first will observe that article VIII of the AMEX constitution provides for AMEX members to "arbitrate all controversies arising in connection with their business between or among themselves or between them and their customers as required by any customer's agreement or, in the absence of a written agreement, if the customer chooses to arbitrate."[184] Such arbitration will be conducted under the Exchange's arbitration procedures, except "if any of the parties to a controversy is a customer, the customer may elect to arbitrate before the American Arbitration Association in the City of New York, unless the customer has expressly agreed, in writing, to submit only to the arbitration procedure of the Exchange."[185]

Second, the customer will contend that this language, when considered along with the typical statements in brokerage agreements that limit arbitration "in accordance with the rules, then obtaining," confers a right upon the customer to arbitrate before the AAA.[186] More particularly, the assertion is that the AMEX constitutional provision allowing customers to "elect to arbitrate before the American Arbitration Association in the City of New York" is a "rule," as contemplated in the brokerage agreement.[187] Several recent decisions, however, have effectively closed the "AMEX window."

In *PaineWebber, Inc. v. Pitchford*[188] the customers sought to litigate a dispute with their broker before the AAA instead of before an SRO sponsored panel, relying on the aforementioned legal arguments.[189] Noting that the *McMahon-Rodriguez* line of cases has increased the importance of this issue, the United States District Court for the Southern District of New York resolved the matter against the customers and the AMEX window theory.[190] The court relied on *Hybert v. Shearson Lehman/American Express, Inc.*[191] in finding that " '[t]he "rules" referred to in the contract . . . refer to the arbitration procedures of the three organizations, not to their constitutions or other general provisions for resolving member disputes,' " and that " '[t]he intent expressed in the language of the contract . . . is to create a

---

Rep. (CCH) ¶ 94,717, at 93879 (S.D.N.Y. Sept. 14, 1989); Hybert v. Shearson Lehman/American Express Inc., No. 84 C 10327, slip op. (N.D. Ill. June 7, 1989).

184. AMEX Const. art. VIII, § 9062 (1) (1989).

185. *Id.* § 9063(2)(c).

186. *See Pitchford*, Fed. Sec. L. Rep. at 93,884; Friedman, *Securities Case Law, Recent Developments*, N.Y.L.J., Nov. 6, 1989, at 3, col. 3.

187. *Pitchford*, Fed. Sec. L. Rep. at 93,884; Dyer, *supra* note 181, in SECURITIES ARBITRATION 1989, *supra* note 8, at 338-40; Friedman, *supra* note 186, at 3.

188. [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,717, at 93,879 (S.D.N.Y. Sept. 14, 1989).

189. *Id.* at 93,880.

190. *Id.* at 93,884-86.

191. *Hybert*, No. 84 C 10327, slip op. at 1.

choice of three arbitration forums.' "[192]

Accordingly, the court in *Pitchford* also concluded that the contractual references to "rules" meant the arbitration procedures of the three electable organizations, not their constitutions.[193] In holding that the agreement limited the parties' selection of arbitration forums to the three specifically named in the arbitration clause and excluded the AAA, the court declined to create a fourth electable forum, a forum that had neither adopted the Uniform Code of Arbitration, nor been envisioned as an arbitral alternative by the parties themselves.[194]

As an alternative basis for compelling arbitration in one of the forums specified in the brokerage agreement, the court quoted from *Creative Securities Corp. v. Bear Stearns & Co.*,[195] a Second Circuit case which held that "private agreements of the parties, such as the customer agreements here in issue, 'can validly modify the arbitration provisions of [an SRO] as they apply to the parties to such agreements.' "[196] Thus, the arbitration agreement in that case "may be said to override the AMEX constitution's provisions relating to arbitration before the AAA, such that the parties intended only to provide for arbitration before an SRO."[197]

The *Pitchford* court also proceeded to make an assumption that was not particularly well founded, but bears major—and unfortunate—implications for the prospects in the courts, of customers who believe that nonindustry arbitral forums are their only hope for truly

---

192. *Pitchford*, Fed. Sec. L. Rep. at 93,884-85 (quoting *Hybert*, slip op. at 10).

193. *Id.* at 93,885.

194. *Id.*

195. 671 F. Supp. 961 (S.D.N.Y. 1987), *aff'd mem.*, 847 F.2d 834 (2d Cir. 1988).

196. *Pitchford*, Fed. Sec. L. Rep. at 93,885 (quoting *Creative Securities*, 671 F. Supp. at 966-67).

197. *Id.* The court also explained that Litigation Release No. 12,198 [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,437, at 80,377 (Aug. 7, 1989), had no effect on its holding. That Release, which prohibits arbitration agreements that limit customers to a single arbitration forum, was adopted specifically to negate the holding in Roney & Co. v. Goren, 875 F.2d 1218 (6th Cir. 1989), which upheld the enforceability of such an agreement. Litigation Release No. 12,198, *supra*, at 80,378; *see also* Friedman, *supra* note 186, at 7, col. 1.

The court also held that claimants who had not signed customer agreements, or whose customer agreements did not contain arbitration agreements, were free to avail themselves of the AMEX Window, when the brokerage firm involved was a member of the AMEX. *Pitchford*, Fed. Sec. L. Rep. at 93,886. The court added, however, that only the AAA forum in New York is available in such circumstances, because "the provision of the AMEX constitution pursuant to which a member of the AMEX agrees to allow customers to elect arbitration 'before the [AAA] in the City of New York' is clear and unequivocal: 'in the City of New York' specifically states the venue of such arbitration proceedings." *Id.* Thus, however inconvenient it may be for claimants, in those instances when the AMEX Window is available to pursue AAA arbitration, that claimant must be prepared to travel to New York City to conduct the hearing, because "[t]here is no other reasonable way that this term could be construed without being superfluous." *Id.* The deterrent effect of such a conclusion on the choice to invoke the AMEX Window is both harsh and evident.

impartial and fair dispute resolution in a post-*McMahon-Rodriguez* era. The court "assume[d]," in a footnote, that because "the SRO forums are SEC approved and regulated . . . they are more experienced than the AAA in dealing with the types of disputes in question."[198]

First, in all due respect to the SEC's legal mandate under the securities laws and its extensive interaction with the SROs in formulating these new rules, it is a *non sequitur* to state that simply because of this approval and regulation the SRO forums are somehow more experienced than the AAA at securities arbitration. Second, quite apart from the significant fact that an arbitration system only need be competent and "sufficiently experienced," rather than "more experienced," the real problem with the court's statement is that it no doubt will be interpreted by some as a definitive, although sub silentio, conclusion, in fact and in law. With no apparent basis in empirical evidence, the court strongly suggests that a major, national organization, founded in 1926 with the broad purposes of "foster[ing] the study of arbitration, . . . perfect[ing] its techniques and procedures under arbitration law, and . . . advanc[ing] generally the science of arbitration"[199] is not as competent as the SRO forums to arbitrate disputes between broker-dealers and their customers. The SEC, it should be noted, appears to take a quite different view.[200]

Although it is doubtful that customers are in any real danger of proindustry bias in SRO sponsored arbitration, customers should nevertheless have the option to choose a nonindustry forum.[201] Investor con-

---

198. *Id.* (citation omitted).

199. *See* AM. ARBITRATION ASS'N, A GUIDE FOR COMMERCIAL ARBITRATORS 31 (apparently quoting from the purposes statement of the AAA organizational documents). It should be noted that the AAA has reevaluated and amended its securities arbitration rules; they became effective as of January 1, 1989. AM. ARBITRATION ASS'N, SECURITIES ARBITRATION RULES; *see also* Robbins, *supra* note 15, in SECURITIES ARBITRATION 1989, *supra* note 8, at 32. Robbins states that "Of the 50,000 AAA arbitrators in 1989, approximately 1,400 are qualified to hear securities cases. Of that number, 804 are affiliated with the securities industry, 89 are customer attorneys and 540 are knowledgeable about securities but have no affiliation with the industry." *Id.* at 32 (citing Friedman, *Securities: The Latest Developments*, N.Y.L.J., Mar. 9, 1989, at 3, col. 1).

200. *See* Letter from SEC Market Regulation Division Director Richard G. Ketchum to all members of the Securities Industry Conference on Arbitration (SICA) (Sept. 10, 1987) (recommending the adoption of numerous measures to enhance securities arbitration). The letter stated:

> *Increasing Pressure on SRO Arbitration Systems*
>
> SRO arbitration case load has increased dramatically in the past five years and is growing rapidly. We recommend that SICA encourage broker-dealers to include in their arbitration clauses the option of using AAA arbitration as well as SRO arbitration forums. A choice of forums could reduce case load and the case turnaround time of SRO sponsored forums.

Id. Although the SEC's recommendation focused on the reduction of SRO arbitration case load and turnaround time, the SEC obviously would not have made such a recommendation had it not deemed the AAA a competent forum in which to conduct securities arbitration.

201. After serving as an arbitrator in numerous industry-sponsored arbitrations, the Author does not view such proceedings as basically fraught with the dangers claimed to be present by the

fidence in arbitration as a meaningful dispute resolution vehicle will be enhanced, and, likewise, the industry's concerns about economy and efficiency also will be satisfied. The AAA in many instances draws from the same persons used in industry arbitration, and thus the competence of the panels should be comparable.[202] Finally, greater cooperation and coordination between the AAA and the securities industry arbitration system only could improve both systems, with beneficial results for all concerned.

B. Preparation for the Hearing

Without adequate prehearing preparation rules, investors are especially at risk because the brokerage firm probably will possess not only most of the pertinent documents and other evidence, but also will have advance knowledge of the applicable rules, guidelines, and practices.[203] At the same time, an investor's complaint, particularly when the investor proceeds pro se, may be vague and incomplete, therefore leaving the broker-dealer at a disadvantage in case preparation.[204] The solution to these problems must strike the proper balance between flexibility and specificity, in order to allow all parties access to relevant information without rendering arbitration uncharacteristically burdensome and legalistic.[205]

The new rules have improved substantially the opportunity for fair and complete prehearing preparation. Like the old rules, the new ones encourage the parties to "cooperate . . . in the voluntary exchange" of information "to expedite arbitration."[206] Similarly, the new rules also

---

various critics of SRO arbitration. *But see* Dyer, *supra* note 181, in SECURITIES ARBITRATION 1989, *supra* note 8, at 335-36. Whatever is the reality of SRO arbitration integrity, rules that are decidedly protective of all participants' rights must be present. The reasons for strong SRO rules are twofold. First, it is imperative that the rules serve both a preventive and a deterrent function, thus warding off biased action to the detriment of investors; this function is necessary because such bias is certainly a possibility. Second, it is equally important that the rules demonstrate to investors, in form and in substance, the SROs' intention to operate fairly.

202. *See supra* note 199.

203. In the Author's own experience as an arbitrator, before the new rules, complaining customers were hampered occasionally in their case presentations by a less than rigorous discovery system in SRO sponsored arbitration. This observation means neither that the system could not be made to work effectively nor that a rigid, bureaucratic maze should have been set in place. The new rules will make the avenues of discovery much more definite and clear, while retaining the flexibility necessary for arbitration to bring to bear its traditional advantages.

204. Not only are customers' complaints sometimes rather incomprehensible, but also, their eventual presentations at hearings may or may not reflect the claims they appeared to make in their initial papers.

205. *See* Katsoris, *supra* note 97, at 287 n.52.

206. *See, e.g.*, NYSE ARBITRATION RULES, *supra* note 146, Rule 619(a). The new Rule provides:

(a) Requests for Documents and Information.

provide for subpoena powers, directing of appearances, and the exchange of documents to be introduced at the hearing.[207]

The new rules introduce substantial improvements with respect to the prehearing phase, notably through procedures providing for Prehearing Conferences,[208] prehearing decisions by an arbitrator when necessary,[209] and means of handling "information requests"—including depositions—as well as objections to such requests.[210] Therefore, these current rules appear to provide a sufficient basis for achieving proper prehearing preparation in the full range of cases that come to arbitration.

C. *Arbitrator Conflicts of Interest*

The conflict of interest issue goes to the heart of the debate surrounding arbitration and its fitness as the major avenue of recourse for claims based on brokerage account activity. What justice can there be

---

> The parties shall cooperate to the fullest extent practicable in the voluntary exchange of documents and information to expedite the arbitration. Any request for documents or other information should be specific, relate to the matter in controversy, and afford the party to whom the request is made a reasonable period of time to respond without interfering with the time set for the hearing.

Id.

207. *See, e.g., id.* Rule 619(f). NYSE Arbitration Rule 619(f) provides:

> The arbitrator(s) and any counsel of record to the proceedings shall have the power of the subpoena process as provided by law. All parties shall be given a copy of the subpoena upon its issuance. The parties shall produce witnesses and present proofs to the fullest extent possible without resort to the subpoena process.

Id. NYSE Arbitration Rule 619(g) allows the arbitrators to direct the appearance of any person employed by or associated with any NYSE member firm, as well the production of records in the possession or control of such persons or members, without the subpoena process. *See, e.g., id.* Rules 619(a)-(c). These rules set forth a somewhat more extensive scheme for document production and information exchange. *See infra* notes 208-10 and accompanying text.

208. *See, e.g.*, NYSE ARBITRATION RULES, *supra* note 146, Rule 619(d)(1). Rule 619(d)(1) allows a party, an arbitrator, or the Director of Arbitration to request a prehearing conference to achieve agreement regarding:

> [A]ny issues that relate to the pre-hearing process or to the hearing, including but not limited to, the exchange of information, exchange or production of documents, identification of witnesses, identification and exchange of hearing documents, stipulation of facts, identification and briefing of contested issues, and any other matters which will expedite the arbitration proceedings.

Id. Additionally, issues not resolved at the hearing may be referred to an arbitrator. *Id.* Rule 619(d)(2).

209. *See, e.g., id.* Rule 619(e) (providing essentially that all unresolved issues related to the discovery process, whether subpoenas, information requests or directing of appearances, may be resolved by an arbitrator or, if necessary, by the full arbitration panel).

210. *See, e.g., id.* Rules 619(a)-(c) (setting forth requirements, including time schedules, for making information requests, objecting to such requests, and for exchanging documents and identifying witnesses to be presented at the hearing). Only document exchange and witness identification related to direct examination are required. The arbitrators may exclude any documents not exchanged or witnesses not identified. *Id.*

for a complaining (or defending) investor, so goes the argument, when claims are heard in industry affiliated forums with panels of arbitrators who have close ties to the industry?[211] The argument has considerable resonance, not only because of its implications as to just adjudication of investor claims and defenses, but also because of its relevance to pervasive concerns about the integrity of the capital markets generally. It is for these reasons that the SROs proposed, and the SEC approved, substantial provisions guaranteeing protection against conflicts of interest by arbitrators, but at the same time encouraging the creation of arbitration panels containing persons experienced and knowledgeable in the resolution of complex financial issues. Because the rules represent a creditable "effort to address possible perceptions of bias,"[212] they only will be summarized briefly below, followed by several observations and proposals.

Central to the rules is the definition of a "securities arbitrator," a position whose holder is usually in the minority on the arbitration panel but possesses invaluable expertise.[213] The definition of an arbitrator "from the securities industry" is as follows:

> 1. a person associated with a member, or broker/dealer, government securities broker, government securities dealer, municipal securities dealer or registered investment adviser, or
> 2. has been associated with any of the above within the past five (5) years, or
> 3. is retired from or spent a substantial part of his or her business career in any of the above, or
> 4. is an attorney, accountant or other professional who devoted twenty (20) percent or more of his or her professional work effort to securities industries clients within the last two (2) years.[214]

The definition of a "public arbitrator" encompasses all remaining persons who seek to be arbitrators, with an important exception for spouses of securities arbitrators.[215]

---

211. *See* Galberson, *When the Investor Has a Gripe*, N.Y. Times, March 29, 1987, § 3, at 1, col. 1. " 'The [brokerage] houses basically like the current [arbitration] system because they own the stacked deck.' " *Id.* at 8, col. 1 (quoting Sheldon H. Elsen, Chairman of the ABA Task Force on Securities Arbitration); *see also* Quinn, *supra* note 10.

212. Exchange Act Release No. 26,584 (Mar. 1, 1989), 54 Fed. Reg. 9955, 9957 (1989) (proposing amendments to the NASD Rules of Fair Practice).

213. *See, e.g.*, NYSE ARBITRATION RULES, *supra* note 146, Rule 607(a)(1) (providing that unless a public customer requests otherwise, the panel shall consist of a majority of nonindustry arbitrators).

214. *See id.* Rule 607(a)(2). The NASD and AMEX rules differ in certain significant respects. *See* NASD CODE ARBITRATION P. § 19(c)(1)-(4); AMEX R. 602(c)(1)(i)-(iv); *infra* notes 229-38 and accompanying text.

215. NYSE ARBITRATION RULES, *supra* note 146, Rule 607(a)(3); AMEX R. 602(c)(2); NASD CODE ARBITRATION P. § 19(d) (excluding investment advisers, unlike the NYSE and AMEX rules). The Rules specify that:

> An arbitrator who is not from the securities industry shall be deemed a public arbitrator. A person will not be classified as a public arbitrator if he or she has a spouse or other member of

Because information about the arbitrators assigned to a case is important, the rules require that the parties be provided with the arbitrators' names and employment histories for ten years, as well as any specific information on conflicts of interest, and that the parties may make further inquiry concerning any arbitrator's background.[216] Additionally, each arbitrator sustains a "continuing duty" to ascertain and disclose:

> Any direct or indirect financial or personal interest in the outcome of the arbitration; . . . [and] [a]ny existing or past financial, business, professional, family or social relationships that are likely to affect impartiality or might reasonably create an appearance of partiality or bias . . . with any party or its counsel, or with any . . . witness . . . [whether through the arbitrator directly or through] members of their families or their current employers, partners or business associates.[217]

The Director of Arbitration may remove an arbitrator based on conflicts of interest;[218] or a party may challenge any or all arbitrators for cause, as well as make one peremptory challenge.[219] "In order to insure continued investor confidence in the arbitration process," the New York Stock Exchange submitted *Guidelines for Classification of Arbitrators* along with its proposed rule amendments.[220] This policy statement is mainly an interpretive guide, and its effect will be to tighten further the conflict of interest restrictions of the actual rules. The document reiterates the negative implications in the rules of a prospective arbitrator having "close ties" with the industry, but goes further in establishing a clear bias toward honoring challenges in such instances.[221] For example, spouses of industry personnel are precluded from serving as arbitrators of any type. In general, "[a]ny close question on arbitrator classification or on challenges for cause shall be decided in favor of public customers."[222]

These rules represent a commendable effort at achieving both the form and substance of fairness in arbitration, but they do generate several areas deserving comment. One such area is the perception some-

---

the household who is a person associated with a registered broker, dealer, municipal securities dealer, government securities broker, government securities dealer or investment adviser.

NYSE ARBITRATION RULES, *supra* note 146, Rule 607(a)(3).

216. *See, e.g.*, NYSE ARBITRATION RULES, *supra* note 146, Rules 608, 610.

217. *See, e.g., id.* Rule 610(a).

218. *See, e.g., id.* Rule 610(d).

219. *See, e.g., id.* Rule 609 (previously in effect and not amended) (providing that "each party shall have the right to one peremptory challenge . . . [and] [t]here shall be unlimited challenges for cause").

220. NYSE GUIDELINES FOR CLASSIFICATION OF ARBITRATORS [hereinafter GUIDELINES].

221. The Guidelines focus particularly on family relatives of broker-dealers and professionals with close ties to, or past affiliations with, broker-dealers, providing that challenges for cause in those cases shall be "honored" or "sustained." *See id.*

222. *Id.* As to spouses, the guidelines provide that "Spouses of securities industry personnel may not serve as arbitrators." *Id.*

times advanced that the administration of arbitration by industry affiliated organizations presents the specter of bias.[223] A second important issue is the NASD's rule that would allow investment advisers to be public arbitrators.[224] A third area for consideration is the failure of the NASD and the AMEX to adopt the NYSE rules that extend from three years to five years the period that a securities industry employee who leaves the industry must wait before being qualified to serve as a public arbitrator, and that prohibit a securities industry employee who has worked for the industry for a substantial period of time and then leaves the industry from ever serving as a public arbitrator.[225] A final area deserving comment is the rule allowing an attorney, accountant, or other professional who devotes less than twenty percent of his or her professional work effort over the previous two years to securities industry clients to serve as a public arbitrator.[226]

As to the first area, the present efforts at reform, as well as the quality of future arbitrations, either will diminish or sustain any suspicions about improper industry influence on SRO sponsored arbitration. Additionally, rules could create or, if it already exists, clarify, the public customer's right to choose arbitration before the American Arbitration Association, which is not connected with the industry. Indeed, the SEC has recommended, although for different reasons, that arbitration clauses include the AAA as an option.[227] Although the suspicions in this regard may have little or no foundation,[228] the clearly expressed grant

---

223. *See supra* note 211.

224. NASD CODE ARBITRATION P. § 19(c)(1); *see also* NYSE ARBITRATION RULES, *supra* note 146, Rule 607(a)(2); AMEX R. 602(c)(1)(i).

225. NYSE ARBITRATION RULES, *supra* note 146, Rule 607(a)(2); *see also* NASD CODE ARBITRATION P. § 19(c)(2), (3); AMEX R. 602(c)(1)(ii), (iii).

226. *See, e.g.*, NYSE ARBITRATION RULES, *supra* note 146, Rule 607(a)(2)[4].

227. Letter from Richard Ketchum of the SEC Market Regulation Division to all SICA members (Sept. 10, 1987). The SEC Division Chief stated that because the

> SRO arbitration case load has increased dramatically in the past five years and is growing rapidly. . ., [w]e recommend that SICA encourage broker-dealers to include in their arbitration clauses the option of using AAA arbitration as well as SRO arbitration forums. A choice of forums could reduce case load and the case turnaround time of SRO sponsored forums.

Id.

228. In the Author's experience, SRO arbitrations not only have been fair, but also have gone to great lengths to render justice to the customer in both form and substance. On the specific issue of bias by securities arbitrators in SRO sponsored hearings, see Robbins, *supra* note 15, in SECURITIES ARBITRATION 1989, *supra* note 8, at 167. David Robbins observes:

> It would surprise many practitioners to know that most determinations of liability are unanimous and that it is usually the industry arbitrator leading the charge against the improper conduct. . . .
>
> . . . .
>
> Even the SEC has commented, "The review did not disclose any problems involving the use of industry arbitrators in investor arbitration."

Id. (quoting Letter from Richard G. Ketchum, SEC Director of Market Regulations, to James E.

of the aforementioned choice only could add to the integrity of arbitration generally and industry sponsored arbitration in particular.

The NASD chose to depart from the Securities Industry Conference on Arbitration proposals on conflicts of interest by deleting investment advisers from the list of persons automatically designated to be securities arbitrators. The NASD reasons that "registered investment advisers are generally well-informed and well-qualified individuals and are, in fact, independent from the securities industry . . . . Further, such individuals represent an untapped source whose enrollment would serve to replenish the NASD's pool of public arbitrators," which would be reduced significantly by rules that will expand substantially the scope of persons automatically designated as securities arbitrators and exclude spouses.[229]

As is true with the rules as a whole, the crucial question remains whether this reasoning will be well received by the investing public. On the subject of conflicts of interest, perception is an especially sensitive issue. Those with only a generalized understanding of the investment adviser's function might view that professional as just another securities industry expert. Also, because of the complexity of the securities field and the expanding and overlapping roles of different types of businesses, one can never know what conflicts potentially exist. Nonetheless, the strength of the overall scheme of conflict of interest rules bodes well for acceptance of the NASD's position. In particular, the classification, disclosure, and removal provisions of the rules[230] provide a dependable basis for determining and remedying the existence of potential conflicts of interest for investment advisers seeking to serve as public arbitrators.

What should be added to the NASD rules, however, are the policy guidelines submitted to the Commission by the NYSE.[231] These guidelines—including the policy statement favoring public customers' chal-

---

Buck, Senior Vice President & Secretary of NYSE (Sept. 10, 1987)). It should be noted, however, that Mr. Meyer of the North American Securities Administrators Association appears to have an answer for just such observations. *See Arbitration Reform Hearings*, *supra* note 6, at 283 (statement of James C. Meyer). Mr. Meyer stated that "[s]ecurities industry professionals contend that arbitrators are unbiased and oftentimes harsher on their colleagues than others might be in arbitration proceedings. That may or may not he true. But even if it is, the perception of fairness is as important as the reality of fairness." *Id.*; *see also supra* notes 181, 201-02 and accompanying text.

229. Exchange Act Release No. 26,584, *supra* note 212, at 9957 (proposing amendments to the NASD Rules of Fair Practice); *see also* Exchange Act Release No. 26,805, *supra* note 21, at 80,103 n.19 (approving the NASD proposal, notwithstanding its variation from those of the NYSE and the AMEX). The Release states: "It is not inconsistent with the [Securities Exchange] Act to permit this divergence in approach among the SROs." *Id.*

230. *See, e.g.*, NYSE ARBITRATION RULES, *supra* note 146, Rules 607-611.

231. *See supra* notes 220-22 and accompanying text; *see also* Exchange Act Release No. 26,805, *supra* note 21, at 80,102 n.13.

lenges—would enhance substantially the NASD's attempt to strike a fair and equitable balance between the need to add numerous competent persons to the pool of public arbitrators without any compromise in the integrity of the arbitration system. As it now stands, the NASD rule is certainly sufficient, but it undoubtedly should be a special focus of the monitoring and evaluation that the SEC and the SROs already intend to perform on an ongoing basis.[232]

The difference between the NYSE's five year waiting period before a securities industry employee can serve as a public arbitrator and the NASD's and the AMEX's three year period is probably not crucial.[233] The SEC, in approving the two periods, viewed them "both [as being] consistent with the [Securities Exchange] Act."[234] It is fortunate for the NASD that the SEC holds this opinion, because the rationale offered for not extending the three year period, namely that the pool of public arbitrators in the era of the new rules will be sizably diminished and impermissibly small, may not be very strong, and the measure will need SEC support.[235]

The NASD and the AMEX should adopt the NYSE's rule prohibiting a securities industry employee who has worked in the industry for a substantial period of time from becoming a public arbitrator.[236] The rule is a sound one. It recognizes the simple yet strong possibility of deep-seated bias, conscious or unconscious, on the part of an individual who has worked in an industry. As such, the rule precludes the eventuality that a majority of an arbitration panel, in any given case, could consist of persons oriented toward the securities industry.[237] At a mini-

---

232. Exchange Act Release No. 26,805, *supra* note 21, at 80,114 n.59. The Release provides that:

> Open and continuous dialogue with the SROs on all matters, including the need to consider regulatory changes, is essential to the working of the scheme of self-regulation established hy Congress. This process has included significant public dialogue, and all commenters' views . . . have been considered in the context of . . . rule filings pursuant to Rule 19b-4.

Id.; *see also* Karmel, *supra* note 153.

233. *Compare* NYSE ARBITRATION RULES, *supra* note 146, Rule 607(a)(2)[2] *with* NASD CODE ARBITRATION P. § 19(c)(2) *and* AMEX R. 602(c)(1)(ii).

234. Exchange Act Release No. 26,805, *supra* note 21, at 80,103.

235. This opinion is based on the Author's personal experience and knowledge, based on discussions with arbitrators who rarely are called to hear cases. Perbaps scheduling confiicts, the sheer administrative burden of contacting the arbitrators, and conflicts of interest account for some of the absence of opportunities. As to the conflict of interest problem, however, many of these persons are from academia, thus virtually always eliminating the problem, or are securities lawyers who do not represent brokerage firms. In any event, many never are contacted in the first instance.

236. Exchange Act Release No. 26,805, *supra* note 21, 80,102.

237. Because the average panel consists of three persons, with one of them formally required to be from the securities industry, a second panel member with very strong ties to the industry could, in effect, produce a panel with a majority of securities arbitrators.

mum, guidelines with a bias in favor of customer challenges for cause should be adopted, and in any event, this area should be carefully evaluated in the future by the SEC and the SROs.[238]

The provision in the rules allowing an attorney, accountant, or other professional to become a public arbitrator who devotes less than twenty percent of his or her professional work effort to securities industry clients elicited one important concern during the comment period of the proposed rules: that percentage work effort, although less than twenty percent, could constitute a professional's " 'single greatest and most consistent source of income.' "[239] Moreover, the rule does not appear to account for the scenario in which a professional, or his or her firm, is engaged in a determined effort to increase significantly its percentage of securities industry clients.[240]

A balanced solution to this potential problem lies in combining disclosure in such instances with a strong presumption in favor of a customer's challenge for cause. The NYSE guidelines exemplify such a presumption. Through this combination, a customer could analyze the information that is now required to be disclosed, in order to determine whether the possibility of bias exists on the part of a prospective arbitrator, and feel secure that his or her reasonable expressions of concern truly will be respected. On the other hand, to the extent disclosure does not reveal a proper basis for exclusion, the arbitration process will have been enhanced by virtue of the addition of an arbitrator with actual knowledge of, and experience in, the securities industry.

D. Arbitrator Awards

Certain features of the arbitration process prior to the new rules elicited basic and instinctual suspicions about arbitration. The awards, which could be substantial in amount, were final and binding.[241] The

---

238. *See, e.g.*, NYSE ARBITRATION RULES, *supra* note 146, Rule 607(a)(2)[]; *supra* note 225.

239. Exchange Act Release No. 26,805, *supra* note 21, at 80,102 (quoting Comment of Public Citizen, a public interest organization).

240. The prime example would be a firm, small or large, that has decided upon representation of securities firms as an important new growth area, deserving of increased resources—including development and marketing efforts—but that at present obtains only 19% of its income from such firms. Obviously, under such a scenario, this firm's new emphasis and future vision of its business indicate that certainly its partners who formulate and implement policy will have a potential conflict of interest when they are designated to serve as public arbitrators. Additionally, considering the realities of firm dynamics, a young associate who wants to advance might be even more vulnerable to biased decision making, and thus that person also could have a significant conflict of interest.

241. NASD CODE ARBITRATION P. § 41(a),(b), provide:

(a) All awards shall be in writing and signed by a majority of the arbitrators or in such manner as is required by applicable law. Such awards may be entered as a judgment in any court of competent jurisdiction.

arbitrators were not required to write opinions stating their findings of fact and conclusions of law.[242] No record of the proceedings was required to be kept.[243] Moreover, the award was not made public.[244] Such characteristics prompted Justice Harry Blackmun to dissent from the majority's conclusion in *McMahon* that the quality and effectiveness of arbitration has improved vastly since the *Wilko* decision. Blackmun noted that records of arbitration proceedings were not required, that arbitrators were not bound by precedent, and that judicial review remained substantially limited to those grounds set forth in the Arbitration Act as well as a vague "manifest disregard" of law standard.[245]

The new rules are partially responsive to these criticisms. For example, one rule requires that "[a] verbatim record by stenographic reporter or tape recording of all arbitration hearings shall be kept."[246] The purpose of this rule is to "provide a sufficient record for review."[247] Additionally, certain other rules mandate that the award contain specific information central to the decision and that information contained

---

(b) Unless the applicable law directs otherwise, all awards rendered pursuant to this Code shall be deemed final and not subject to review or appeal.

Id.; *see also* Robbins, *supra* note 15, in SECURITIES ARBITRATION 1989, *supra* note 8, at 166.

What most distinguishes arbitration from litigation is that there is no right to appeal an arbitration Award. The statutory and judicially created grounds for vacating or modifying an Award are limited and, until recently, tbe Award gave no idea of the issues decided. Because of the new SRO Award rule, more focus will be placed on the arbitrator's deliberative process.

Id.

242. The new rules set forth no specific requirements in this area. The common practice is for arbitrators rarely to write opinions, and usually only in complex, special cases. *See, e.g.*, NASD CODE ARBITRATION P. § 41(a), (b).

243. *See* NASD CODE ARBITRATION P. § 37 (repealed) (stating that "[u]nless requested by the arbitrators or a party or parties to a dispute, no record of an arbitration proceeding is required to be kept").

244. *See id.* § 41(c) (repealed) (providing only for service of the award upon the parties or their counsel, and not mentioning any form of public availability of the award).

245. 482 U.S. 220, 259 (1987) (Blackmun, J., dissenting). Specifically, Blackmun stated:

Even those wbo favor the arbitration of securities claims do not contend, however, that arbitration has changed so significantly as to eliminate the essential characteristics noted by the *Wilko* Court. Indeed, proponents of arbitration would not see these characteristics as "problems," because, in their view, the characteristics permit the unique "streamlined" nature of the arbitral process. As at the time of *Wilko*, preparation of a record of arbitration proceedings is not invariably required today. Moreover, arbitrators are not bound by precedent and are actually discouraged by their associations from giving reasons for a decision. Judicial review is still substantially limited to tbe four grounds listed in § 10 of the Arbitration Act and to the concept of "manifest disregard" of the law.

Id. (footnote and citations omitted).

246. *See, e.g.*, NYSE ARBITRATION RULES, *supra* note 146, Rule 623; *see also* AMEX R. 614 (the word "all" was omitted in the AMEX rule).

247. *See* Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Changes, Proposed Rule Changes by New York Stock Exchange, Inc. Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934, at 5. (File No. SR-NYSE-88-29) [hereinafter NYSE Rule 19b-4 proposal].

in the award be made public.[248] These rules have the purpose of "assur[ing] the parties that the arbitrators have considered all the issues raised and damage claims made . . . [and therefore that] the parties will have a better understanding of the decision . . . [thus creating an] increase [in] investor confidence in the arbitration process."[249]

Laudable though these rules may be, certain key issues going to the heart of the debate surrounding arbitration still must be addressed. The focus of these issues is the reluctance of arbitrators and arbitration rules to require that written opinions accompany awards. This practice raises questions relative to how some basic objectives common to any system of laws are to be met. Such objectives include providing guidance in areas of potential conflict, such as broker-customer relations, as to what standards of conduct should be observed. Another goal is to provide a known and coherent body of jurisprudence in this area for everyone's benefit, including legal counsel seeking to analyze and prepare cases, and arbitrators seeking to render fair and consistent awards in difficult cases.[250] A further objective is to provide a basis for judicial challenges in proper instances.[251]

In addition to the specter of greater administrative expense and time, arbitrators may prefer not to produce written opinions because they realize the arbitration decisional process does not involve strict, consistent application of pertinent legal principles. In fact, arbitrators are most likely not to perform in-depth legal research. Their bases for awards generally rest on what is "fair," "just," or "sensible" under the circumstances.[252]

---

248. *See, e.g.*, NYSE ARBITRATION RULES, supra note 146, Rule 627(e),(f). The Rule specifically states:

> (e) The award shall contain the names of the parties, a summary of the issues in controversy, the damages and/or other relief requested, the damages and/or other relief awarded, a statement of any other issues resolved, the names of the arbitrators, the date the claim was filed and the award rendered, the location of the hearing, and the signatures of the arbitrators concurring in the award.
>
> (f) The awards shall be made publicly available, provided however, that the name of the customer party to the arbitration will not be publicly available if he or she so requests in writing.

Id.

249. NYSE Rule 19b-4 proposal, *supra* note 247, at 5.

250. *See* Exchange Act Release No. 26,805, *supra* note 21, at 80,109-11 (discussing the arguments in favor of and against written opinions and deciding that a requirement that such opinions accompany all awards is unnecessary at the present time).

251. *Id.* at 80,109.

252. The Author's experience in numerous hearings has shown that this practice is common. It should be noted, however, that there is generally at least one arbitrator who is quite conversant with the applicable legal principles. *See* Dyer, *supra* note 181, in SECURITIES ARBITRATION 1989, supra note 8, at 346. Dyer states: "If the arbitration panel is fair (and educated), they are just as likely to 'follow the law' as any court." *Id.*

Perhaps ironically, and certainly in most of the smaller cases, this approach to decision making probably works to the benefit of the complaining investor. For example, an investor suing in court on claims of churning and unsuitability under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder not only must plead the facts with "particularity" under relevant procedural rules,[253] but also must plead and prove complex elements of the cause of action, such as scienter, materiality, causation, and reliance.[254] Indeed, the arbitrators' standards reflect, in a common sense way, basic rationales of the more technical legal theories of customers' typical claims. Further, they are probably more responsive to the customer's actual concern over broker conduct at issue. Arbitrators' standards in general relax the legal theories in a manner that works to the customer's benefit. To the extent the customer prevails, the brokerage firm would have considerable difficulty meeting legal tests for setting aside an award. Under the Arbitration Act, only fraud, evident partiality, or misconduct by arbitrators, or failure to render an award will suffice for a legal challenge.[255] Additionally, when arbitrators have acted in "manifest disregard" of the law, an award can be overturned.[256]

Brokers' claims, on the other hand, usually are based in breach of contract. These claims, much like less legally technical customer claims, such as breach of fiduciary duty, are generally highly fact sensitive and require some understanding of brokerage and capital market concepts, operations, and standards.[257] Arbitration, with its relaxed procedural rules and substantive standards—and under circumstances in which bias, or the perception of it, are eliminated by virtue of procedures that assure the entire system's integrity—would appear to serve the interests of justice and economy quite well in most of these small cases.

---

253. FED. R. CIV. P. 9(b) (providing, in pertinent part, that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity").

254. For an extended discussion of the extensive proof requirements for establishing a cause of action under Rule 10b-5 and other provisions, see Hood, *Arbitration and Litigation of Public Customers' Claims Against Broker-Dealers after* McMahon, 19 ST. MARY'S L.J. 541 (1988); Robbins, *supra* note 15, in SECURITIES ARBITRATION 1989, *supra* note 8, at 66-73.

255. *See* 9 U.S.C. § 10(a), (b), (d) (1988); *see also* French v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 784 F.2d 902, 908-09 (9th Cir. 1986). Considerable deference is shown in the cases to the arbitrators' determination. *Id.*

256. *See* Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 258 (1987); Wilko v. Swan, 346 U.S. 427, 436-37 (1953). For a thorough discussion of the grounds for vacating or modifying an award, see Robbins, *supra* note 15, in SECURITIES ARBITRATION 1989, *supra* note 8, at 183-90.

257. Clearly, in these cases the arbitrators are concerned with determining all the facts, as well as discerning specific industry practices, often through expert testimony, and rendering a decision based on equitable principles. The legal concepts, however, usually are known to at least one arbitrator on the panel, and in any event, the underlying legal theories are relatively simple.

It is the complicated cases, however, that should not be left to the highly generalized adjudicatory process of arbitration as it is usually conducted. These cases, often quite large and usually very complex both legally and factually, upset the balance of interests that serves so well in the simpler cases and pose greater possibilities of inadequate or unjust awards.[258] In such cases, the parties should be allowed access to the courts. While present rules, however, allow the arbitrators "either upon their own initiative or at the request of a party [to] dismiss the proceeding and refer the parties to the remedies provided by applicable law," no guidelines exist to aid the arbitrators in making such a decision.[259]

Although guidelines should remain flexible to provide for varying types of matters that can be deemed appropriate for referral, certain areas should receive prime consideration. Class actions, cases challenging the legitimacy of industry practices, and matters that will involve extensive discovery all would appear to qualify, if not for a presumption, for a hard look by the arbitrators regarding whether judicial deliberation might be the best deliberative vehicle.[260]

IV. CONCLUSION

More than ever before, securities arbitration must meet its traditional challenge of balancing flexibility, economy, and convenience with clarity, reason, and justice. The confluence of various legal and eco-

258. In the large, complicated cases, the parties proceed as though they were in court anyway, with numerous briefs, motions, expert and lay witnesses, and extensive time requirements. Additionally, and understandably, their expectations regarding rulings on motions and the like are much more demanding. Certainly, many of these cases are susceptible to treatment by a well-selected arbitration panel. At a minimum, however, a conscious, formal decision should be made as to whether the matter should continue in arbitration.

259. NASD CODE ARBITRATION P. § 16.

260. The rules and procedures should be amended to provide guidelines with these examples and to require the arbitrators to consider formally whether the case is appropriate for referral. *See Testimony Before the Subcomm. on Securities of the Comm. on Banking, Housing, and Urban Affairs, United States Senate, Concerning Issues Related to Small Investors* (Feb. 8, 1990) (testimony of the Securities and Exchange Commission given by Richard G. Ketchum, Director, Division of Market Regulation, and Joseph I. Goldstein, Associate Director, Division of Enforcement). Director Ketchum noted in his testimony that "SICA and the SROs have not yet identified specific areas where alternative rules for large and complex cases would be appropriate. As more complex disputes come to arbitration, the need for appropriate procedures will heighten. The [Securities and Exchange] Commission staff has encouraged SICA to renew its efforts to develop flexible alternative rules for complex cases." *Id.* at 33.

Notably a first edition of an arbitrators' manual has been distributed to arbitrators, and it addresses, among other matters, the referral of cases to the courts. "The manual suggests that it may be appropriate to refer parties to the courts in cases where all necessary parties have not agreed to arbitration, class actions and derivative actions, cases that involve substantial legal issues for which the establishment of legal precedent is important, and cases in which witnesses or documents essential to a fair and final decision are unavailable in the arbitral forum. *Id.* at 32 n.44.

nomic events is directing increasingly large numbers of cases to this forum. The pervasive, adverse impacts of ineffective regulation of the securities markets on investors, the capital markets, and the economy are becoming clear.[261] As such, there can be no place for the traditional criticisms of arbitration to be, or even appear to be, true.

The challenge to arbitration is particularly serious because of the securities industry's affiliation with the major arbitration programs. The industry has made commendable progress, however, in reversing some of the form and substance creating the basis of past suspicions and doubts. This Article's discussions and recommendations are intended to be a modest contribution to that progress. Inclusion of the ideas expressed here into the body of applicable rules, along with constant monitoring by the SEC, the industry, and the public, will surely make the entire securities arbitration system worthy of the great responsibilities that now have devolved upon it.

261. *See generally* BRADY REPORT, *supra* note 173; SEC DIV. OF MT. REGULATION, THE OCTOBER 1987 MARKET BREAK (1988); INTERIM REPORT OF THE WORKING GROUP ON FINANCIAL MARKETS (1988).