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Arbitration of Securities Disputes: Rodriguez and New Arbitration Rules Leave Investors Holding a Mixed Bag

WILLIAM C. HERMANN*

INTRODUCTION

The 1980’s were a boom decade for the capital valuation of corporate America. The Dow Jones Industrial Average rose 1914.46 points, or 228.25 percent, over the decade.¹ This growth was fueled in part by public participation in the market.² With the growth, however, came closer media attention to Wall Street’s flaws. Headlines screamed of Boesky’s fall, the crash of October, 1987, and the settlement of criminal charges against the meanest 300 pound gorilla on the Street, Drexel Burnham Lambert, which left its junk-bond financing whiz, Michael Milken, twisting in the wind.³ This publicity at the end of the decade shook Wall Street to its very foundation, threatening the public participation that helped create the boom. The volume of trading by individual investors since 1987’s “market correction” fell off dramatically as investors became concerned that Wall Street’s playing field is not level.⁴ The public’s skepticism forcefully supports Justice Blackmun’s recent contention that “the industry’s abuses towards investors are more apparent than ever.”⁵

A development that might have the greatest impact on individual investors, however, did not receive much attention in the popular press. The Supreme Court made it clear, first in Shearson/American Express Inc. v. McMahon,⁶

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6. 482 U.S. at 220.
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and most recently in *Rodriguez de Quijas v. Shearson/American Express Inc.*,\(^7\) that pre-dispute agreements to arbitrate any claims a customer might have against her broker will be enforced. Customers who agree to arbitrate their claims will no longer have the option of pursuing remedies in the federal courts. This pro-arbitration position of the Supreme Court effectively leaves the SEC as the sole protector of individual investors.

In Part I this Note will address the *McMahon* and *Rodriguez* decisions, and the foundation upon which they stand. Part II of this Note will then examine the arbitration process, focusing on its benefits to consumers. Part III, however, will argue that the arbitral forum is currently inadequate to protect the rights given to investors by Congress from the erosion precipitated by an activist Supreme Court. The Note concludes that the SEC, as the last guardian of investors, should take action to protect the statutory rights of investors in the securities market.

I. The Road to *Rodriguez*

Congress has always intended to provide a judicial forum for securities disputes. In section 22(a) of the Securities Act of 1933 (Securities Act),\(^8\) Congress granted jurisdiction over offenses and violations of the Securities Act to the district courts of the United States and the United States courts of any Territory. In section 27 of the Securities Exchange Act of 1934 (Exchange Act),\(^9\) Congress granted exclusive jurisdiction to the same federal courts over violations of the Exchange Act.

Congress did not intend to allow the waiver of these statutory rights to a judicial forum. Both section 14 of the Securities Act\(^10\) and section 29(a) of the Exchange Act\(^11\) stipulate that conditions binding any person to waive

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The district courts of the United States and the United States courts of any Territory shall have jurisdiction of offenses and violations under this subchapter and under the rules and regulations promulgated by the Commission in respect thereto, and, concurrent with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by this title.

*Id.*


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

*Id.*


11. 15 U.S.C. § 78cc(a) (1988). The statute reads: “Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void.” *Id.*
compliance with any provisions of these acts shall be void. These statutory sections manifest congressional intent to provide and secure a judicial forum for securities disputes. It is in the light of this clear congressional intent that the McMahon and Rodriguez developments should be examined.

A. The Wilko Doctrine

Prior to 1986, lower federal courts consistently invalidated boilerplate, pre-dispute arbitration clauses contained in customer account agreements with broker-dealers. This accorded with congressional intent, as recognized by the Supreme Court's opinion in Wilko v. Swan, which held that the Securities Act barred enforcement of such pre-dispute agreements regarding claims under section 12(2) of the Securities Act.

The Wilko Court held that section 12(2) created a right to select a judicial forum that could not be waived because of the anti-waiver provisions of section 14 of the Securities Act. The Wilko Court reasoned that the arbitration process was unlikely to adequately protect the federal policies inherent in the securities statutes.

Lower federal courts regularly extended the Wilko reasoning to claims arising under section 10(b) of the Exchange Act and Rule 10b-5 through the similar anti-waiver provision contained in section 29(a) of the Exchange Act. However, two Supreme Court cases brought the practice of extending Wilko to section 10(b) claims under considerable scrutiny. These cases caused a split among the federal courts when determining the arbitrability of claims under section 10(b) and Rule 10b-5. The Supreme Court granted certiorari in the McMahon case to resolve this conflict.

B. The McMahon Background

Eugene and Julia McMahon opened a series of accounts with the brokerage firm of Shearson/American Express Inc. (Shearson) between 1980 and 1982.

15. Wilko, 346 U.S. at 431, 434-35.
20. See McMahon, 482 U.S. at 249 n.8 (Blackmun, J., concurring in part and dissenting in part).
21. Id. at 225.
22. The McMahon case has been extensively reviewed elsewhere, so an exhaustive analysis
Two of the customer account agreements signed by Julia provided that any controversy arising out of these accounts would be submitted to arbitration.²³

In 1984, the McMahons brought suit against Shearson and Mary Ann McNulty, their registered representative at Shearson, in the United States District Court for the Southern District of New York.²⁴ The complaint alleged that McNulty, with the knowledge of Shearson, had churned their accounts, withheld material information, and made false statements in violation of section 10(b) of the Exchange Act and SEC Rule 10b-5.²⁵ The complaint also stated a claim under the Racketeer Influenced and Corrupt Organizations Act (RICO),²⁶ and state law claims for fraud and breach of fiduciary duties.²⁷

Shearson moved to compel arbitration of the claims under section 3 of the Federal Arbitration Act of 1924 (Arbitration Act)²⁸ based on the arbitration clauses in the customer account agreements. The district court granted the motion to compel arbitration on all the issues except the RICO claim.²⁹ The district court relied upon the strong national policy of enforcing existing arbitration agreements—a policy embodied in the Arbitration Act—in compelling the McMahons to submit to arbitration.³⁰ The Court of Appeals for the Second Circuit, however, applied the Wilko doctrine and refused to compel the arbitration of the 10(b) claims.³¹ The court of appeals also upheld the district court's ruling that the RICO claims were non-arbitrable.³² The McMahons' victory, however, was short-lived.


²³ McMahon, 482 U.S. at 222-23. The arbitration agreement provided in part: "Unless unenforceable due to federal or state law, any controversy arising out of or relating to my accounts, to transactions with you for me or to this agreement or the breach thereof, shall be settled by arbitration...." Id. at 223.

²⁴ Id.
²⁵ Id.; see also supra notes 16-17.
²⁷ McMahon, 482 U.S. at 223.
³⁰ Id. at 389.
³² Id. at 98-99.
C. McMahon in the Supreme Court

The Supreme Court reversed and remanded to the court of appeals in a 5-4 decision on June 8, 1987, holding that both the section 10(b) and the RICO claims were arbitrable. Writing for the majority, Justice O'Connor first insisted that the Arbitration Act should provide the starting point for the analysis, and went on to state that the Act "mandates enforcement of agreements to arbitrate statutory claims," absent fraud or an explicit congressional ban on waivers of federal court standing.

The McMahons had argued that section 29(a) of the Exchange Act forbids the waiver of the section 27 jurisdictional provision reserving the federal courts' exclusive jurisdiction over Exchange Act claims. The Court rejected this argument, stressing that section 29(a) precludes only waivers regarding compliance with substantive obligations of the Exchange Act. Section 27 does not impose any substantive duties; therefore, reasoned the Court, section 27's grant of jurisdiction may be waived.

Without explicitly addressing or overruling Wilko's application to the Securities Act, the majority then asserted that Wilko did not extend to Exchange Act claims. In reaching this conclusion, the majority limited Wilko by reading it narrowly. The McMahon Court reinterpreted Wilko as holding that a waiver of judicial forum was unenforceable only because of the perceived inadequacy of arbitration to enforce rights under the Securities Act in 1953, when Wilko was decided.

The Court went on to reject the McMahons' argument that pre-dispute agreements are void under section 29(a) because they result from broker overreaching and inequality of bargaining power. The Court claimed that "[t]he voluntariness of the agreement is irrelevant to this inquiry . . . ." The Court made this claim even while conceding that if a broker maneuvered a customer into an agreement, it would be grounds for revocation of the contract under ordinary principles of contract law, which embody the standard for revocation under section 2 of the Arbitration Act. The Court's

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33. McMahon, 482 U.S. at 220. Since a unanimous court agreed that the McMahons' RICO claim was subject to arbitration, this Note will not address that issue further.

34. Id. at 226.

35. Id. at 227.

36. Id. at 228-29.

37. Id.

38. Id. at 230.

39. Id. at 230-31.

40. 9 U.S.C. § 2 (1988). This section states:

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole of any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, 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.

Id.
refusal to consider coercion by brokers also seems at odds with the Court's earlier assertion that a well-founded claim of fraud or excessive economic power would result in the revocation of an arbitration agreement.\footnote{McMahon, 482 U.S. at 226.}

Finally, the majority rejected the McMahons' argument that the conference report regarding the 1975 amendments to the Exchange Act ratified the federal courts' extension of \textit{Wilko} to Exchange Act claims, even though "[i]t was the clear understanding of the conferees that this amendment did not change existing law, as articulated in \textit{Wilko v. Swan} . . . ."\footnote{Id. at 236-37 (quoting H.R. CONF. REP. No. 229, 94th Cong., 1st Sess. 111, \textit{reprinted in} 1975 U.S. CODE CONG. & ADMIN. NEWS 179, 342).} The Court rejected any argument that congressional inaction could equal endorsement of the extension of \textit{Wilko} to Exchange Act claims. The Court assumed that because Congress failed to change existing law, the \textit{Wilko} issue was left to the courts.\footnote{Id. at 238.} This is a surprising instance of judicial activism from the Court's new conservative majority.

The Court's key argument was that the competence of the arbitral tribunals is now much higher than it was in 1953.\footnote{Id. at 233-34.} The Court is further supported by the virtual plenary authority of the SEC to oversee and regulate arbitration proceedings,\footnote{Id. at 232; see also 9 U.S.C. § 10.} even though "judicial scrutiny of arbitration awards necessarily is limited."\footnote{Id. at 232; see also 9 U.S.C. § 10. This section gives the standard for vacation of arbitration awards as follows: 

\begin{itemize}
  \item[(a)] Where the award was procured by corruption, fraud, or undue means.
  \item[(b)] Where there was evident partiality or corruption in the arbitrators, or either of them.
  \item[(c)] Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced.
  \item[(d)] Where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.
  \item[(e)] Where an award is vacated and the time within the agreement required the award to be made has not expired the court may, in its discretion, direct a rehearing by the arbitrators.
\end{itemize}

\textit{Id.}} The Court's faith in the competence of the arbitral tribunals, however, does not appear to be supported by any evidence other than Justice O'Connor's gut feeling "that there is no reason to assume . . . that arbitrators will not follow the law."\footnote{Id.} Nor does the Court's faith in the SEC's oversight
capacity seem to reflect the reality of that agency's current role in the market.48

Justice Blackmun, in a vigorous dissent, rejected the majority's conclusion that the Exchange Act claim was arbitrable.49 He first reasoned that the legislative history of the 1975 amendments to the Exchange Act imply a congressional intent to allow the trend of extending Wilko to section 10(b) claims.50 Justice Blackmun then interpreted the Wilko decision as an affirmation of the policies inherent in the Securities Act, especially the goal of investor protection, rather than as a limited attack on arbitration's perceived inadequacy for the pursuit of section 12(2) claims in 1953.51 Justice Blackmun focused on similar policy concerns evident in the Exchange Act, finding that both acts "have the same basic goal"52 and merit the same generous application of Wilko.

Beyond criticizing the Court's institutional competence to eviscerate Wilko, Justice Blackmun further expressed doubt that arbitration, even assuming improvement since 1953, provides a substantively adequate forum for the protection of investor rights.53 Specifically, the apparent impossibility of judicial review, given the standards of the Arbitration Act,54 the lack of a record, and the failure to mandate written awards were issues that troubled Justice Blackmun.55 He also noted a danger in putting investors into an arbitral arena largely controlled by the very industry with which they are in dispute.56

Finally, Justice Blackmun saw a pretense in the majority's reliance on the oversight authority of the SEC. He realized that SEC review powers are, in practice, virtually non-existent.57 Overall, he viewed the majority's result as an abandonment of the individual investor by the judiciary at a time when judicial protection was sorely needed.58

Justice Stevens, in a single page, also dissented from the portion of the Court's judgment on the arbitrability of the Exchange Act claims. Like Justice Blackmun, he relied on an institutional analysis, arguing that the Court had overstepped its proper judicial role and, in effect, acted as a quasi-legislature.59

48. See infra text accompanying note 57.
50. McMahon, 482 U.S. at 247 (Blackmun, J., concurring in part and dissenting in part).
51. Id. at 251-52.
52. Id. at 256. For an excellent discussion of the legislative history, policies, scope, goals and great reforms of the federal securities acts, see Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).
53. Id. at 257.
54. Id. at 257-58; see also supra note 46.
55. McMahon, 482 U.S. at 259.
56. Id. at 260.
57. Id. at 265-66.
58. See supra text accompanying note 5.
59. McMahon, 482 U.S. at 268 (Stevens, J., concurring in part and dissenting in part).
Justice Stevens argued that the longstanding history of the Wilko doctrine should be modified, if at all, by the legislature.60

D. The Small Step to Rodriguez

After the McMahon decision, brokerage customers with grievances continued to attempt to circumvent arbitration. Since McMahon had not explicitly overruled Wilko, investors would bring their cases in federal court under the only avenue left open to them: section 12 of the Securities Act.61 It was only a matter of time before the Supreme Court would move to block this path by invalidating Wilko completely.

On May 15, 1989, a 5-4 majority of the Supreme Court, in Rodriguez de Quijas v. Shearson/American Express, Inc.,62 decided that Securities Act claims were subject to arbitration in the same way as the Exchange Act claims in McMahon. This holding finally overruled Wilko. The petitioners were a group of unsophisticated investors in Brownsville, Texas, who lost over $400,000 they had invested at the local Shearson office. The investors had signed arbitration agreements with Shearson. However, they eventually sued Shearson in federal court, alleging that their money was lost due to unauthorized and fraudulent trades made by their broker.63

The court of appeals reversed a district court order to submit all claims to arbitration except for those raised under section 12(2) of the Securities Act.64 Noting that the district court had relied on Wilko, the court of appeals reversed and ordered the parties to submit all claims to arbitration.65 The court of appeals reasoned that the Supreme Court's subsequent rulings have reduced Wilko to "obsolescence."66

In affirming the court of appeals, the Supreme Court agreed completely with the appellate court's assessment of Wilko (although the justices took the court of appeals to the woodshed for not following existing precedent).67 "We now conclude 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."68

60. Id.
61. See supra note 14.
63. Id. at 1918-19.
65. Id.
66. Id. at 1299.
68. Id. at 1922.
Writing for the majority, Justice Kennedy interpreted the \textit{Wilko} Court's deference to the Securities Act and its policy of investor protection as simply a case of judicial hostility to arbitration.

That view has been steadily eroded over the years, beginning in the lower courts. The erosion intensified in our most recent decisions upholding agreements to arbitrate federal claims raised under the Securities Exchange Act of 1934. To the extent that \textit{Wilko} rested on suspicion of arbitration as a method of weakening the protections afforded in the substantive law to would-be complainants, it has fallen far out of step with our current strong endorsement of the federal statutes favoring this method of resolving disputes.\textsuperscript{69}

To the \textit{Rodriguez} majority, the policies behind the Arbitration Act, a less significant piece of legislation both in terms of size and scope than the landmark securities statutes, apparently outweighed any other policy considerations.

Justice Kennedy went on to compare the anti-waiver provisions of the Securities Act with the anti-waiver provisions of the Exchange Act. He found that section 29(a) of the Exchange Act\textsuperscript{70} is almost identical to section 14 of the Securities Act.\textsuperscript{71} The Court in \textit{McMahon} had refused to read section 29(a) as prohibiting enforcement of pre-dispute arbitration agreements. Given the similarity of the statutes, the \textit{Rodriguez} Court refused to prohibit them under the Securities Act.\textsuperscript{72}

The majority then reiterated Justice O'Connor's argument from \textit{McMahon} that investors should have faith in the plenary powers of the SEC:\textsuperscript{73}

And in \textit{McMahon} we explained at length why we rejected the \textit{Wilko} Court's aversion to arbitration as a forum for resolving disputes over securities transactions, especially in light of the relatively recent expansion of the Securities and Exchange Commission's authority to oversee and to regulate those arbitration procedures. We need not repeat those arguments here.\textsuperscript{74}

This refusal to address the practical reality of the SEC's extremely limited oversight power completely ignored Justice Blackmun's concerns in \textit{McMahon}, and the realities of the current environment.\textsuperscript{75}

Concluding his analysis, Justice Kennedy cited the strong language of the Arbitration Act and argued that \textit{Wilko} and \textit{McMahon} are incompatible as a matter of securities law.\textsuperscript{76}

\textsuperscript{69} \textit{Id.} at 1920 (citing \textit{Scherk}, 417 U.S. at 506; and \textit{McMahon}, 482 U.S. at 220).
\textsuperscript{70} 15 U.S.C. § 78cc(a).
\textsuperscript{71} 15 U.S.C. § 77n.
\textsuperscript{72} \textit{Rodriguez}, 109 S. Ct. at 1921.
\textsuperscript{73} \textit{See supra} text accompanying note 45.
\textsuperscript{74} \textit{Rodriguez}, 109 S. Ct. at 1921 (citations omitted).
\textsuperscript{75} \textit{See supra} text accompanying note 57; \textit{see also infra} notes 135-39 and accompanying text.
\textsuperscript{76} \textit{Rodriguez}, 109 S. Ct. at 1921-22.
It also would be undesirable for the decisions in Wilko and McMahon to continue to exist side by side. Their inconsistency is at odds with the principle that the 1933 and 1934 Acts should be construed harmoniously because they "constitute interrelated components of the federal regulatory scheme governing transactions in securities."

The Supreme Court then overruled Wilko and affirmed the judgment of the court of appeals.78

In a caustic dissent, Justice Stevens asserted that "when our earlier opinion gives a statutory provision concrete meaning, which Congress elects not to amend during the ensuing 3 1/2 decades, our duty to respect Congress' work product is strikingly similar to the duty of other federal courts to respect our work product."79 This is a more forceful version of the argument he put forth in McMahon. In an angry swipe at the "conservative" members of the majority, he added that "[j]udges who have confidence in their own ability to fashion public policy are less hesitant to change the law than those of us who are inclined to give wide latitude to the views of the voters' representatives on non-constitutional matters."

However, none of this vituperative language had any effect on the final result in the case. The Supreme Court, in what may be seen as a blatant attempt to reduce the federal docket, has made itself undeniably clear: Wilko is dead and arbitration is king. The Supreme Court appeared unwilling to completely pull its finger out of the litigation dike in the McMahon case, perhaps because it did not want to project the image of a judiciary willing to abandon the individual investor and the policies of the securities statutes with one bold stroke. However, by stretching the process out over two different cases, the Supreme Court has accomplished a drop by drop erosion of these policies as complete as that caused by a flash flood.

II. WHERE RODRIGUEZ LEAVES INVESTORS

The decision in Rodriguez De Quijas v. Shearson/American Express, Inc.,81 following the earlier reasoning in Shearson/American Express, Inc. v. McMahon,82 mandates the enforcement of valid pre-dispute arbitration agreements for claims arising under any of the securities regulations. The broad pronouncements in the Rodriguez and McMahon decisions have ushered in a new era that favors arbitration in securities disputes. This Note will now examine what the arbitration process has in store for individual investors.

77. Id. at 1922 (citations omitted).
78. Id.
79. Id. at 1923 (Stevens, J., dissenting).
80. Id.
SECURITIES ARBITRATION

A. The Advantages of Arbitration

Some commentators feel that the arbitral forum is fully competent to protect the policies at the heart of the federal securities laws.83 These commentators posit the vast experience of the arbitrators, the percentages of awards given to customers in arbitration and the extensive use of arbitration in other countries as proof of the fairness and efficiency of the arbitration process.84

Other commentators feel that investors will be helped procedurally by the less formal nature of the arbitration proceedings.85 Specifically, investors who typically have been dismissed from court for failing to properly state a claim may benefit from the relaxed pleading requirements in the arbitral forum.86 Similarly, the absence of discovery could theoretically be an advantage to the customer.87 Also, since arbitrators are not bound by the rules of evidence, investors may be able to introduce hearsay evidence of conversations with their brokers,88 although this could prove to be a double-edged sword.

Recently, the New York Stock Exchange commissioned the accounting firm of Deloitte Haskins & Sells to perform a survey regarding customer-originated claims that were terminated by arbitration, litigation or settlement.89 The survey used cases terminated during the most recent three month periods for which the firm could obtain data.90 These periods ranged from October 1, 1987, to June 30, 1988.91

The survey shows that arbitration has a distinct advantage for investors in both speed and size of awards. For example, the average elapsed time to the termination of a case through litigation was 599 days; whereas, the average elapsed time for cases referred to arbitration was 434 days.92 For cases that began as litigation and were subsequently transferred to arbitration, the average elapsed time shot up to 1,056 days.93 While this data does show a pronounced difference, one would expect arbitration, for all its supposed "speed," to be even faster.

83. Bedell, Harrison & Harvey, supra note 22, at 8.
84. Id. at 8-10.
85. See, e.g., Hood, supra note 22, at 584.
86. Id. at 579-81.
87. Id. at 584. However, Professor Hood struggles with a hypothetical for this point, and it is unclear what he has in mind.
88. Id. at 584-85.
89. See APPENDIX, data accumulated from letter from Deloitte Haskins & Sells to the New York Stock Exchange (undated) (copy on file at the Indiana Law Journal). The accounting firm of Deloitte Haskins & Sells recently merged with the accounting firm of Touche Ross to become Deloitte & Touche.
90. Id.
91. Id.
92. Id.
93. Id.
The size of the awards as a percentage of the original claim in cases resolved through arbitration was 19.57% versus a minimal 2.60% for litigation.\textsuperscript{94} When the cases transferred from litigation to arbitration are factored in, the payments as a percentage of the original claim for all of the arbitrated cases falls to 14.81%.\textsuperscript{95} However, the difference between arbitration and litigation might well be due to a tendency to bid up a claim when entering litigation, as opposed to a possibly more realistic approach when entering arbitration. The legal costs of arbitration to the brokerage firms were also significantly lower as a percentage of the payments than the legal costs of litigation.\textsuperscript{96} Obviously, this is one of the main attractions arbitration agreements have for the industry.

Although this survey does not show how many of the claims were successful in either litigation or arbitration, other surveys tend to show that a majority of arbitrated cases result in awards for the customers.\textsuperscript{97} Also, data suggests that the SEC has received few complaints regarding arbitration.\textsuperscript{98}

Although the Deloitte survey does have its limitations, it seems to endorse the cost-effectiveness of the arbitration procedure for both the brokerage firm and the customer. The arbitration process appears to be both competent to protect the goals of the securities laws and cost-efficient in providing a cheaper, quicker alternative dispute forum. While this Note ultimately argues that arbitration is flawed in its present form, its real advantages to the customer and industry cannot be denied.

\textbf{B. Recent Arbitration Rule Changes Beneficial to Investors}

In 1977, the SEC invited the establishment of the Securities Industry Conference on Arbitration (SICA) to serve as an advisory body.\textsuperscript{99} The SICA, after reviewing then-existing arbitration procedures as an alternative dispute resolution forum, developed the Uniform Code of Arbitration.\textsuperscript{100} The self-regulatory organizations (SROs), which perform the actual arbitrations, have modeled their own arbitration codes after this Uniform Code.\textsuperscript{101} This Note will use the National Association of Securities Dealers, Inc. (NASD) Code of Arbitration Procedure (CAP) (1989) as a model of the rules governing

\textsuperscript{94. Id.}
\textsuperscript{95. Id.}
\textsuperscript{96. Id.}
\textsuperscript{97. See Bedell, Harrison & Harvey, \textit{supra} note 22, at 9 n.57.}
\textsuperscript{98. See SIA Response Letter, \textit{supra} note 2, at 5.}
\textsuperscript{100. Id.}
\textsuperscript{101. Id.}
arbitration in the securities industry. The NASD is the only national SRO, and its CAP closely tracks the Uniform Code.

On September 10, 1987, the SEC sent SICA a letter expressing concerns with the present industry-sponsored arbitration. In response to these concerns, the SROs filed proposals to amend the arbitration rules. The SEC approved the proposals on May 10, 1989.

The SROs' amendments affect many different areas of the rules including, among others, service of pleadings, appointment of replacement arbitrators on a panel, availability of small claims procedures, the number of arbitrators required to hear a claim, and arbitration fees. This Note will focus on the rule changes affecting discovery, the classification of arbitrators, the preservation of a record, the content and availability of arbitration awards, and predispute arbitration clauses.

1. Discovery

The arbitration rules had required parties to exchange documents informally and voluntarily. However, parties would sometimes refuse to turn over documents they felt were privileged. Sanctions for parties resisting production were inadequate to assure compliance with the rules.

Under the amendments to CAP section 32, information requests must either be satisfied or objected to within thirty calendar days from the date of service. The party who made the request has ten days to respond to an objection. A party whose information request has not been satisfied may refer the matter to a pre-hearing conference. If the pre-hearing conference is unable to resolve the issues, the CAP provides for the appointment of a single public arbitrator to issue subpoenas, direct appearances of witnesses, require the production of documents, compel depositions, and set deadlines to expedite the hearing.

The SEC believes "that the SRO discovery rule proposals should increase the efficiency of arbitration proceedings and provide substantially greater protections for public participants." These rules should encourage compliance with discovery by industry parties who often have the only documents relevant to the case. Individual investors thus derive a substantial benefit from the new discovery rules.

103. SEC Order, supra note 99.
104. Id.
105. Id. at 21,145-55.
106. Id. at 21,149.
107. Id.
108. Id.
109. Id.
110. Id. at 21,150.
2. Classification of Arbitrators

Although the 1988 CAP had required that a majority of each arbitration panel be public arbitrators and a minority be industry arbitrators, in practice this distinction tended to be hazy. The NASD recognized that often attorneys, accountants and other professionals who practiced in the securities area or worked closely with the securities industry were designated as non-securities industry arbitrators. This practice had led to public skepticism toward the purported neutrality of the arbitration panels. Given their close ties to the industry, a panel made up of affiliated professionals might not achieve the goal of neutrality that the drafters of the CAP obviously desired.

The SEC, while pleased with the mixed industry/public arbitration panel theory, was also concerned with the classification of persons with clear affiliations to the securities industry as non-industry arbitrators. Section 19 of the CAP has now been amended to include a definition of industry arbitrator that includes professionals who provide services to securities industry clients; such as attorneys, accountants, and other professionals who devoted twenty percent or more of their work effort to industry clients within the last two years. Additionally, anyone who worked in one of the “traditional” industry positions within the last three years would be classified as an industry arbitrator. The arbitrators will also be required to disclose their employment histories for the past ten years, as well as any ties or conflicts of interest between the arbitrator and the parties.

The new classifications and disclosure requirements should refute any appearance that the panel is packed with industry personnel against the public investors. The SEC says that “[t]he changes proposed regarding the classification of arbitrators are very significant to the continued success of SRO arbitration.” These changes should rekindle investor faith in the neutrality of the arbitration process.

3. Preservation of a Record

Section 37 of the CAP addresses the preservation of a record of arbitration proceedings. Historically, a record would not be kept unless one of the parties

112. Id. § 19.
113. Telephone interview with Timothy Scott, Arbitration Counsel at the NASD office in Chicago (Jan. 5, 1989) [hereinafter “Scott”]. The Chicago office is one of four NASD offices in the country that administers the arbitration proceedings.
114. SEC Order, supra note 99, at 21,146.
115. Id.
117. SEC Order, supra note 99, at 21,146.
118. Id.
119. Id. at 21,147.
requested a recording. Further, the party making the request had to bear the cost of transcription. Unless a customer was aware of the provision and able to afford the cost, the record for a possible appeal would be lost. The NASD found that most of the arbitrations went unrecorded. Therefore, most of the customers would be precluded from asserting any of the grounds necessary for vacation of the award under the Arbitration Act.

The SEC requested that the SROs amend their rules to assure that records of arbitration proceedings are made and preserved. "These records are necessary for courts to use in conjunction with any review of the proceedings they may make." Section 37 codifies this requirement. A verbatim record will be kept by either a stenographic reporter or a tape recording. If a party wants to have the record transcribed, the cost will be borne by that party, unless the arbitrators direct otherwise. This amendment will adequately ensure the preservation of a record for appeal. Tape recordings are inexpensive, and it is only fair that the party requesting a transcript bear the expense.

4. Content and Public Availability of Award Decisions

The format of award decisions is dealt with in Section 41 of the CAP. Old section 41(a) of the CAP said, "All awards shall be in writing and signed by a majority of the arbitrators or in such manner as is required by applicable law." These awards often took the form of a dollar value for the customer if she won, or else judgment for the brokerage firm. The awards almost never gave any opinion or holding on the legal theory or factual determination that formed the basis of the award. Many of the monetary awards were not even remotely related to the amount set out as a claim in the pleadings. Without an opinion, investors had no idea how the arbitration panel arrived at the figure in the award, and thus had no basis upon which to claim fraud or any of the other predicates for vacation of the award.

Section 41 of the CAP has now been amended to provide that awards shall contain the names of the parties, the damages or relief requested, a summary of the issues in controversy, the damages or relief awarded, a statement of any other issues resolved, the names of the arbitrators and the signatures of the arbitrators concurring in the award.

120. 1988 CAP, supra note 111, § 37.
121. Scott, supra n.113.
122. See supra note 46 (quoting the text of § 10 of the Arbitration Act which gives the standards for vacation of arbitration awards).
123. SEC Order, supra note 99, at 21,151.
124. Id.
125. 1988 CAP, supra note 111, § 41(a).
126. Scott, supra note 113.
127. SEC Order, supra note 99, at 21,151.
5. Predispute Arbitration Clauses

The SEC had been concerned about the use of mandatory pre-dispute arbitration clauses in customer account agreements. Many investors would not know they were entering an arbitration agreement when they signed a new customer account form.

The SROs developed a rule change designed to improve disclosure to customers opening accounts, and to restrict the content of the arbitration clauses. The change requires that brokers place a notice immediately before the clause. The notice language must inform customers that they are waiving their right to seek remedies in court, that arbitration is final, that discovery is more limited, that the award is not required to contain factual findings or legal reasoning and that a minority of the arbitrators may be from the securities industry.

The new rule requires that this language be highlighted in four ways. First, large or distinguishable type must be used. Second, the disclosure language must be in outline form and noticeable to the readers. Third, a highlighted statement reiterating that the agreement contains an arbitration clause and stating where that clause is located must be included immediately preceding the signature line. Finally, the broker-dealer must give a copy of the agreement, including the arbitration clause, to the customer, who is required to acknowledge receipt of the agreement by signature.

This rule change is a tremendous step forward from the practice of hiding the arbitration clause on the back of a customer agreement that the customers often did not read. The disclosure will heighten investor awareness of some of the strengths and weaknesses in the arbitration process. The disclosure also helps satisfy an important policy inherent in the securities statutes.

Nevertheless, a number of concerns with the fairness and efficacy of the arbitral forum remain that were either unresolved by the recent rule changes or not addressed by the SEC. The next section of this Note will explore these remaining problem areas.

III. Remaining Problem Areas

As noted above, arbitration is not without its drawbacks. These concerns include the lack of evidentiary standards, the lack of effective review by the

128. Id. at 21,153 n.51.
129. Id. A second rule change restricting the content of the arbitration clauses merely prohibits agreements that limit or contradict the rules of any SRO or limit the ability of a party to file an arbitration claim. Id. at 21,154.
130. Id. at 21,153.
131. Id.
132. For an excellent discussion of the disclosure policy, see Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).
SEC, the unavailability of appellate avenues after arbitration, the possible rise of "arbitrator shopping," the lack of written opinions, the absence of articulable standards of law to be applied in arbitration and the practice of requiring arbitration agreements as a condition of doing business with the brokerage firm.

A. Evidentiary Standards

The arbitration system has many procedural rules that are completely different from the rules of procedure that would govern the claims in litigation. Section 34 of the CAP delineates the evidentiary standards that govern arbitrations. It states in full: "The arbitrators shall determine the materiality and relevance of any evidence proffered and shall not be bound by rules governing the admissibility of evidence."133 This completely discretionary standard can be applied in a different manner in every case. The NASD itself recognizes that the rules of evidence are not clear and are applied in a haphazard fashion.134

B. SEC Review

The SEC conducts no review of the efficacy or correctness of arbitrations administered by the SROs or the American Arbitration Association. The SEC can only approve the procedure used in the arbitrations;135 therefore, it has no authority to examine how the substantive law is applied in the arbitrations. Justice Blackmun observed in McMahon that the SEC "does not contend that its 'sweeping authority,' ... includes a review of specific arbitration proceedings."136 He further doubted "whether the Commission could undertake to conduct any such review."137 Upon examination of the SEC's oversight powers in practice, the Court's reliance in McMahon on the "expansive power to ensure the adequacy of the arbitration procedures"138 is without support, and the Rodriguez majority's refusal to address this issue is unjustifiable.139

C. Appellate Avenues Available After Arbitration

Persuading a court to overturn an arbitration award is very difficult. The standard adopted in the Arbitration Act for the vacation of an arbitration

133. 1989 CAP, supra note 102, § 34. This section was not changed by the 1989 amendments.
134. Scott, supra note 113.
136. Id. at 265 (Blackmun, J., concurring in part and dissenting in part) (citation omitted).
137. Id.
138. Id. at 233.
139. See supra text accompanying notes 73-75.
award is extremely strict. The courts normally will not inquire into the substantive basis for the determination of the award. Rather, the courts require a showing of fraud, corruption or similar abuses articulated in section 10 of the Arbitration Act.

The Supreme Court has developed the "manifest disregard" of the law standard as grounds for the vacation of an arbitration award. Professor Lipton points out, however, that this standard has not required arbitrators to comply with the law, but rather to "base their awards on whatever grounds they choose as long as the result is not obviously in conflict with the outcome that would be required by law." In reality, however, the federal courts do not impose even this minimal standard. The courts only require that arbitrators pay "lip service" to the applicable law.

D. Arbitrator Shopping

Brokers will now keep statistics on the performance of the different arbitral tribunals and the different individual arbitrators. Brokers will structure their arbitration clauses to mandate the forum that is most sympathetic to the industry and exclude arbitrators who have an anti-industry history. This "arbitrator shopping" would favor the brokers over the customers and should not be encouraged.

Arbitrator shopping is more dangerous than any forum shopping that can occur in the federal court system. Unlike judicial opinions, arbitration records and awards are not published, and are not, therefore, available for public inspection. The brokers will be the only parties with thorough information on the arbitrators, and they will utilize their informational advantage to the disadvantage of the investors.

E. Lack of Written Opinions

Significantly, the new section 41 of the CAP does not require written opinions. The SEC concluded that:

After careful consideration of whether awards ought to include reasons for arbitrators' awards, as is advocated by Public Citizen and [the Plaintiff Employment Lawyers Association] in their comment letters, we have

141. Id.
143. Lipton, The Standard on Which Arbitrators Base Their Decisions: The SROs Must Decide, 16 SEC. REG. L.J. 3, 8 (1988); see also notes 147-54 and accompanying text.
144. Id. at 10.
145. Even if a contractual choice of court is enforced, the parties would still have no power to select which judge within the district would hear their case.
concluded that it would not be appropriate at this time to require the inclusion of written opinions in awards. This rule change already represents a significant movement in the explication of the arbitral process. We believe that it would be in the public interest to allow the SROs and parties a period of time to adjust to this rule, and to await any independent development on the part of the arbitrators themselves to develop written opinions.\textsuperscript{146}

This position places a great deal of faith and hope in the initiative of the arbitrators.

Arbitrators are unlikely to make themselves targets for the courts by independently writing opinions. A mere record of the proceeding is not enough for an appellate court to apply the "manifest disregard" standard necessary to overturn an arbitration award. Requiring written opinions would eliminate emotionally-driven equitable awards, and would also show what standard of law the panel applied in reaching its decision. A written opinion is necessary to appeal an award. The SEC should have required written opinions, and the passive position it has adopted is a flaw in the otherwise commendable rule changes.

\textbf{F. Standard of Law}

One of the most glaring weaknesses of the arbitration procedure is the failure to specify the standard of law on which the arbitrators must base their decisions. The CAP is completely silent on this matter. Section 35 allows the arbitrators complete discretion when interpreting the Code, but does not make any reference to the substantive law.\textsuperscript{147} Generally, the NASD tries to select arbitrators who have some familiarity with the securities statutes, but no testing procedure is administered.\textsuperscript{148} No mandatory direction as to what standards of law govern arbitrations is given, and only recently did the NASD begin a brief orientation program that attempts to introduce new arbitrators to the substantive law that underlies these disputes.\textsuperscript{149}

In addition, the CAP does not require that the arbitrators be attorneys. The CAP does require that a majority of each arbitration panel not be from the securities industry.\textsuperscript{150} Those from within the securities industry, such as brokers or managers, can apply any standard they desire to these disputes. They might apply what they perceive in their experience to be the applicable law, but they might well be wrong. They may apply what they feel is common industry practice, but this practice might not conform with the applicable securities laws. An industry arbitrator might decide that the broker in the

\begin{footnotesize}
\begin{enumerate}
\item[146.] SEC Order, \textit{supra} note 99, at 21,151.
\item[147.] 1989 CAP, \textit{supra} note 102, § 35. This section was not changed by the 1989 amendments.
\item[148.] Scott, \textit{supra} note 113.
\item[149.] Id.
\item[150.] 1989 CAP, \textit{supra} note 102, § 19.
\end{enumerate}
\end{footnotesize}
dispute did not follow the procedure used by that arbitrator’s firm and rule against the broker even though the broker was complying with the law. The outsiders on the arbitration panel, especially if not trained in the securities laws, might apply the law, or their own sense of business judgment, or basic notions of fairness. As Professor Lipton observes, “there is no clear answer regarding the impact the law should have on an arbitrator’s decision.”

The endless possibilities for different standards indicate that the relevant law is not necessarily the basis for arbitration decisions. This lack of foundation in the law will have the greatest adverse effect on a complex claim involving complicated applications of the securities laws and the RICO statutes.

For instance, suppose a broker was trading options utilizing a complex butterfly-spread strategy for a customer’s discretionary account. This broker’s firm had a floor trader at the options exchange who told the broker that he could skim points on the opening and closing of the options if the broker entered them as market orders. The broker and trader agreed to split the profits. Somehow, the customer discovered this arrangement and wanted to recover his money in an arbitration proceeding. In order to reach the correct application of the law in this case, the arbitrators would have to apply the securities statutes, the rules promulgated under the authority of the securities statutes, SRO rules, exchange rules and the RICO statute. This would be a difficult task even for a court experienced in securities law, much less a broker, accountant or any other arbitrator thrown into the fray.

A decision rooted so precariously in the law could range from the correct application of the law, to a compromise solution, to a result completely at odds with the applicable law. Therefore, there does not seem to be any justification for Justice O’Connor’s assumption in the McMahon opinion that arbitrators will correctly apply the law. There is also no reason to assume that this arbitration procedure will preserve the policy of investor protection underlying the federal securities statutes.

G. Mandatory Arbitration Clauses

In the past, brokerage firms were so enamored with arbitration clauses that they continued to utilize them even in the face of the Wilko decision and its extension to the Exchange Act. However, under Wilko, firms required arbitration agreements at their peril. An investor could always litigate the validity of the agreement in federal court, and the firm would lose. After

151. Lipton, supra note 143, at 7.
152. Id. at 5.
153. McMahon, 482 U.S. at 232; see also supra text accompanying note 47.
154. See supra note 51 and accompanying text.
McMahon and Rodriguez, however, broker-dealers face no such danger, and arbitration agreements are that much more attractive.

In 1988, the SEC conducted a study of sixty-five broker-dealer firms that accounted for 90% of all customer trading accounts in the United States. The survey examined their use of arbitration agreements in 1988. Thirty-nine percent of all cash accounts, 96% of all margin accounts and 95% of the options accounts were subject to mandatory predispute arbitration clauses. Firms such as Merrill Lynch, PaineWebber, A.G. Edwards, Dean Witter and Kidder Peabody, however, did not require such an agreement in their basic cash accounts.\textsuperscript{155}

Given the result in Rodriguez, firms may now legitimately and completely avoid the costs of litigation\textsuperscript{156} and excessive jury awards by requiring customers to enter arbitration agreements 100% of the time for all accounts. If an individual investor subject to an arbitration agreement ever brought a claim in federal court, the firm could escape the litigation through a simple summary judgment motion. Thus, McMahon and Rodriguez will lead all firms pursuing bottom line efficiency to mandate arbitration agreements as a condition of doing business.

The SEC attempts to address this issue by arguing that:

[A]pproval of this rule, which does not include provisions mandating customer choice with respect to the signing of arbitration clauses is consistent with the Act. 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. This is so because a number of broker-dealers, including several large full-service broker-dealers in the country, do not require the signing of account agreements for cash accounts.\textsuperscript{157}

This line of reasoning may have been valid in 1988 when the SEC conducted its survey. But after Rodriguez, this argument does not stand up to scrutiny: The firms will find a new attractiveness in mandatory arbitration agreements, and the availability of court remedies will correspondingly diminish.

The nearly unanimous practice of requiring arbitration agreements in certain types of trading accounts,\textsuperscript{158} prior to the Supreme Court's complete endorsement of arbitration in Rodriguez, demonstrates the extent to which the industry favors these clauses. Now that the Supreme Court has established its policy through a quasi-legislative action, there is no longer any incentive for brokerage firms to omit arbitration clauses from their customer agree-

\textsuperscript{155} SEC Order, \textit{supra} note 99, at 21,153 n.51.
\textsuperscript{156} See \textit{supra} notes 94-96 and accompanying text.
\textsuperscript{157} SEC Order, \textit{supra} note 99, at 21,154 (emphasis added).
\textsuperscript{158} See \textit{supra} text accompanying note 153.
ments, and the practice will continue to grow. Broker-dealers will not continue to allow trading, even on a cash basis, without the protection of an arbitration agreement.

The securities statutes of 1933 and 1934 took the industry out of a purely competitive market situation by imposing regulations on customary broker-dealer behavior that favored the investor. Although some economists may find fault with this, it was a policy decision well within the constitutional competence of the Congress.\(^\text{159}\)

To further its own goals and desires, the Supreme Court has changed the structure of the imperfect market Congress imposed upon the industry. *McMahon* and *Rodriguez* open the door to mandatory arbitration as a universal practice in the securities industry, which Congress never intended to allow. This improper use of judicial power in the face of a congressionally mandated market structure will create and perpetuate an artificially vertical, inelastic supply curve in the market for a court remedy.

The danger in moving toward industry-wide mandatory arbitration is greatest for margin and options account traders. Cash accounts traders typically transact fairly simple buy and sell orders, and any disputes they might have should be easily resolved. In fact, it is precisely this type of account and transaction that would be best resolved in the arbitral forum. However, margin and options traders often utilize complex trading strategies\(^\text{160}\) that may not be easily understood in a court of law, much less in arbitration. The SEC survey shows that these traders are almost always required to agree to arbitration,\(^\text{161}\) and the decision in *Rodriguez* will make that a universal practice.

While the SEC admits an existing market for court remedies in the cash account context, the agency also "recognizes that investors do not have such access with respect to margin and options accounts . . . ."\(^\text{162}\) The SEC puts forth the slim hope that "competitive forces will result in some firms offering margin or options accounts without [arbitration] agreements."\(^\text{163}\) The Supreme Court's move toward an inelastic supply curve in the market for a court remedy will destroy competitive forces in this market. Brokers will not reverse their established practice with options and margin accounts to allow investors to choose the dispute resolution forum. Rather, they will expand the practice of mandating arbitration agreements.

The danger to margin and options account investors will be significant even before mandatory arbitration becomes universal. Investors in today's

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159. The U.S. Constitution explicitly grants to Congress the power ""[t]o regulate Commerce with foreign Nations, and among the several States . . . ."" U.S. Const. art. I, § 8, cl. 3. The commerce power under article I is not shared with the judiciary under article III.

160. For an example of such a complex strategy, see supra text accompanying note 153.

161. See supra text accompanying note 155.

162. SEC Order, supra note 99, at 21,154.

163. Id.
imperfect market are unlikely to know about the few firms that allow a court remedy in the margin and options account context. They are just as unlikely to know the real advantages and disadvantages of arbitration. Investor ignorance has already produced a dangerously inelastic supply curve that will only worsen as the broker-dealers begin responding to the *McMahon* and *Rodriguez* decisions.

The SRO rule changes regarding predispute arbitration agreements are a tremendous improvement in arbitration generally. For example, the formal notice requirements constitute a marked advance. However, an investor is not benefited by notice regarding the limitations on arbitration if she is effectively powerless to avoid an arbitration clause. Thus, there is an unfortunate and very serious limitation built into the CAP amendments. By failing to prohibit brokers from requiring arbitration agreements as a mandatory condition for doing business, the SEC has effectively rendered the rule changes impotent to achieve meaningful investor protection.

At least one state attempt to regulate the practice of mandating arbitration agreements as a condition of doing business was held unconstitutional under

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164. *See supra* text accompanying notes 129-32.

165. Mass. Regs. Code tit. 950, § 12.204(G) (held unconstitutional by Securities Indus. Ass’n v. Connolly, 883 F.2d 1114 (1st Cir. 1989)). The administrative regulation provided:

**Dishonest or unethical practices in the securities business.**

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

a. Requiring on or after January 1, 1989, that a customer located in Massachusetts, other than a customer that is an institutional investor or financial institution specified in 950 CMR 14.401(e), execute either a mandatory pre-dispute arbitration contract or a customer agreement containing a mandatory pre-dispute arbitration clause that is a non-negotiable precondition to effecting transactions in securities for the account of the customer or opening a securities cash account or margin account by the customer with such broker-dealer;

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

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

d. Being found by a court of competent jurisdiction to have violated M.G.L. c.93A in connection with the sale of securities; and

e. Being temporarily or permanently enjoined by any court of competent jurisdiction from violating M.G.L. c.93A in connection with the sale of securities.

*Id.* (based on the CFTC regulations, *infra* note 167) (held unconstitutional in Securities Indus. Ass’n v. Connolly, 883 F.2d 1114, 1124 (1st Cir. 1989)).
the supremacy clause. The federal judiciary has abandoned the investor to the vagaries of the arbitral forum, leaving the SEC as the investor's sole remaining guardian. The SEC should meet the responsibilities of this position by following the example of the commodities and futures trading industry.

The Commodities Futures Trading Commission (CFTC) is the national self-regulatory organization for the commodities industry. It is similar to the NASD within the securities industry. According to CFTC rules, signing an arbitration agreement cannot be made a mandatory condition of doing business with the broker-dealer.

The SEC should duplicate the rules articulated by the CFTC, eliminating the use of mandatory arbitration clauses as a condition of doing business with the firm. There is no justification for treating commodities brokers as inherently different than securities brokers, and the framework of the CFTC rules is difficult to fault. The basic goal is disclosure of the options a customer has when selecting a dispute resolution forum. This complies with the policies at the heart of the federal securities laws: investor protection and disclosure.

Currently, if commodities firms want their customers to enter these agreements, their brokers have to sell these agreements along with the other services they offer. Securities dealers should be made to sell the arbitration agreements in the same fashion. Certainly the brokers can sell arbitration, with its numerous benefits, if they can sell securities.

166. Securities Indus. Ass'n v. Connolly, 883 F.2d 1114, 1124 (1st Cir. 1989).
167. 17 C.F.R. § 180.3 (1989). For instance, section 180.3(b)(6) reads:

(6) The agreement must include the following language printed in large boldface type:

THREE FORUMS EXIST FOR THE RESOLUTION OF COMMODITY DISPUTES: CIVIL COURT LITIGATION, REPARATIONS AT THE COMMODITY FUTURES TRADING COMMISSION (CFTC) AND ARBITRATION CONDUCTED BY A SELF-REGULATORY OR OTHER PRIVATE ORGANIZATION.

THE CFTC RECOGNIZES THAT THE OPPORTUNITY TO SETTLE DISPUTES BY ARBITRATION MAY IN SOME CASES PROVIDE MANY BENEFITS TO CUSTOMERS, INCLUDING THE ABILITY TO OBTAIN AN EXPEDITIOUS AND FINAL RESOLUTION OF DISPUTES WITHOUT INCURRING SUBSTANTIAL COSTS. THE CFTC REQUIRES, HOWEVER, THAT EACH CUSTOMER INDIVIDUALLY EXAMINE THE RELATIVE MERITS OF ARBITRATION AND THAT YOUR CONSENT TO THIS ARBITRATION AGREEMENT BE VOLUNTARY.

BY SIGNING THIS AGREEMENT, YOU: (1) MAY BE WAIVING YOUR RIGHT TO SUE IN A COURT OF LAW; AND (2) ARE AGREEING TO BE BOUND BY ARBITRATION OF ANY CLAIMS OR COUNTERCLAIMS WHICH YOU OR [NAME] MAY SUBMIT TO ARBITRATION UNDER THIS AGREEMENT....

YOU NEED NOT SIGN THIS AGREEMENT TO OPEN AN ACCOUNT WITH [NAME]. SEE 17 CFR 180.1-180.5.

Id. (emphasis added).
CONCLUSION

The Supreme Court has closed the book on the validity of arbitration agreements in brokerage customer account agreements. The majority opinion in *Rodriguez de Quijas v. Shearson/American Express, Inc.* mandates the enforcement of predispute arbitration agreements for any claims arising under the securities statutes, whether they arise under the Securities Act or the Exchange Act. Investors may no longer rely upon congressional provisions for a federal judicial forum in both of the Acts.

The arbitration process has many benefits for the investor. Arbitration has been shown to be quicker and cheaper than litigation for all parties. The relaxed procedural nature of arbitration may also be a benefit. The majority of arbitrated cases seem to result in awards for the investor. However, arbitration has its disadvantages as well.

The lack of evidentiary standards and, more importantly, the lack of any specification of the standard of law to be applied in arbitrations are weaknesses in the arbitration process. The lack of a written opinion, the industry-oriented background of the arbitrators, the limited availability of appellate avenues after arbitration and the involuntary nature of the arbitration agreements are also matters of concern. The *McMahon* and *Rodriguez* cases will only fuel the already increasing number of arbitrations that both the SEC and the NASD will be unable to effectively review. Investors should be made aware of the competing costs and benefits before surrendering their right to a judicial forum.

The Supreme Court decisions leave the SEC as the last protector of the individual investor. SEC approval of the SROs' proposed rule changes was a welcome move towards a fair and efficient system of arbitration as administered by the SROs. However, the SEC failed to rectify important problem areas within this procedure. The SEC must now be very diligent in monitoring these rule changes as they are put into practice. The SEC should also specifically act to correct the problem of mandatory arbitration by imposing rules that mirror the CFTC rules in not allowing brokers to require arbitration agreements. Only in this fashion can the goals of the securities statutes, certainly more significant and far-reaching than the Arbitration Act, be satisfied. And, more importantly, only in this way can the confidence of individual investors, necessary to the health and liquidity of our capital markets, be restored.

# Appendix

Summary of Data Included in the Deloitte Survey*

<table>
<thead>
<tr>
<th></th>
<th>Litigated</th>
<th>Arbitrated</th>
<th>Litigation Transferred to Arbitration</th>
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<tr>
<td><strong>Percentage of total cases</strong></td>
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<td>58.44%</td>
<td>14.40%</td>
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<tr>
<td><strong>Amount</strong> <strong>of original claim</strong></td>
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<td>20,781</td>
<td>20,976</td>
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<td><strong>Amount</strong> <strong>of damage award</strong></td>
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<td><strong>Amount</strong> <strong>of legal costs to the firms</strong></td>
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<td>1,169</td>
<td>1,740</td>
<td>2,909</td>
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<td><strong>Awards as % of original claim</strong></td>
<td>2.60%</td>
<td>19.57%</td>
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<tr>
<td><strong>Legal cost as % of awards</strong></td>
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<td>47.06%</td>
</tr>
<tr>
<td><strong>Average elapsed time (days)</strong></td>
<td>599</td>
<td>434</td>
<td>1,056</td>
<td>577</td>
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</table>

* Total Number of Cases Surveyed = 420
** Dollar Amounts in Thousands