

5-15-1989

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Recommended Citation

Gilbert R. Serota *The Unjustified Furor over Securities Arbitration*, 16 Pepp. L. Rev. Iss. 5 (1989)
Available at: <https://digitalcommons.pepperdine.edu/plr/vol16/iss5/6>

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The Unjustified Furor Over Securities Arbitration

Gilbert R. Serota*

When the United States Supreme Court decided *Shearson v. McMahon*,¹ it closed the largest loophole preventing full enforcement of arbitration clauses in contracts between securities brokers and their customers. The decision made it clear that artful pleading of federal securities laws claims could not preclude enforcement of an arbitration agreement. The resulting outcry was immediate and loud. The plaintiff bar, consumer groups, columnists, state legislators and even members of Congress began to clamor for relief from mandatory, pre-dispute arbitration agreements—a movement that, while somewhat abated, continues today. This article examines whether the furor created by *McMahon* is justified.

I. *SHEARSON V. MCMAHON*

When viewed in light of prior Supreme Court decisions, the *McMahon* case was neither a radical change in the Court's direction nor philosophy. Rather, it was another logical step in the Court's recognition and strong endorsement of private alternatives to judicial dispute resolution.

Its predecessors foreshadowed *McMahon*. In 1983, in *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*,² the Supreme Court held that the district court erred in staying a federal

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1. 107 S. Ct. 2332 (1987).

2. 460 U.S. 1 (1983).

action to enforce an arbitration agreement and deferring to a parallel state case. It declared that federal policy favors arbitration and that Congress's clear intent is "to move the parties to an arbitrable dispute out of court and into arbitration as quickly and easily as possible."³

A year later, in *Southland Corp. v. Keating*,⁴ the Court found that the California Franchise Investment Law,⁵ interpreted by the California Supreme Court as invalidating franchisee-franchisor arbitration agreements, was preempted by the Federal Arbitration Act (FAA).⁶ Again, the Court justified its holding on the basis of a strong national policy favoring arbitration.

In 1985, in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth*,⁷ the Court considered whether federal statutes providing a judicial remedy in automobile dealership disputes implicitly precluded arbitration under agreements between the automaker and dealer. It held that, in view of the "emphatic federal policy in favor of arbitral dispute resolution,"⁸ statutory claims within the scope of an arbitration contract are presumed arbitrable unless Congress's explicit intent to exclude such claims is "deducible from text or legislative history" of the act in question.⁹

In *Dean Witter Reynolds v. Byrd*,¹⁰ the Court held that state law claims pendent to a federal rule 10b-5¹¹ claim were arbitrable even in the face of the inefficiency of dual proceedings. For the purposes of its decision, the Court presumed that rule 10b-5 claims were *not* arbitrable, thus leaving unanswered the issues later raised by *McMahon*.

In 1987, the stage was fully set for *McMahon*. The Court, in *Perry v. Thomas*,¹² held that provisions of the California Labor Code invalidating agreements to arbitrate wage collection actions were preempted by the FAA. It held that Congress's enactment of the Federal Arbitration Agreement was clearly intended to "provide for the enforcement of arbitration agreements within the full reach of the Commerce Clause."¹³

In *McMahon*, the Court answered what was left unaddressed in *Byrd*. It held that claims under the Securities Exchange Act of 1934

3. *Id.* at 22.

4. 465 U.S. 1 (1984).

5. See CAL. CORP. CODE §§ 31000-31516 (West 1977 & Supp. 1989).

6. 9 U.S.C. § 2 (1982).

7. 473 U.S. 614 (1985).

8. *Id.* at 631.

9. *Id.* at 628.

10. 470 U.S. 213 (1985).

11. 17 C.F.R. 240.10b-5 (1988).

12. 482 U.S. 483 (1987).

13. *Id.* at 490.

(the 1934 Act)¹⁴ were arbitrable, rejecting the reasoning of *Wilko v. Swan*,¹⁵ which precluded arbitration of claims under the Securities Act of 1933 (the 1933 Act).¹⁶ Thus, *McMahon* made it clear that characterizing a broker-customer dispute as a federal claim under the 1934 Act, specifically rule 10b-5 promulgated thereunder, would not be condoned as a way to avoid mandatory arbitration.

In light of prior history, it is difficult to argue that *McMahon* was unprecedented or unexpected. Its timing, however, was significant. Only a little more than four months after the *McMahon* decision was issued came the crash of October 19, 1987. That market debacle, in which the Dow Jones Industrial Average plunged over 500 points in a single day and 1000 points in less than a week, created hundreds of potential plaintiffs. *McMahon*, however, left many of them (and their attorneys) without recourse to the courts. This combination of events focused unprecedented attention on the procedures of securities arbitration.

II. THE DEBATE OVER ARBITRATION OF SECURITIES DISPUTES

If the hearings held by the California Senate Commission on Corporate Governance, Shareholder Rights and Securities Transactions in 1988 are indicative, members of the public who oppose arbitration have little actual experience to support their case. Indeed, every nonlawyer who testified against securities arbitration had a common characteristic—never having arbitrated a claim. If they had done so, either under the rules of the New York Stock Exchange (NYSE) or the National Association of Securities Dealers (NASD), they would likely have found that the process offers significant benefits over traditional judicial dispute resolution. These can be briefly summarized as follows:

1. *Efficiency*: Arbitrations are scheduled more regularly than court trials; pre-trial discovery is significantly limited, and proceedings are usually shorter and less costly than court or jury trials. This means that the costs—both to the litigants and the public—are appreciably reduced.

2. *Informality*: Arbitrators are not bound by the traditional rules of evidence.¹⁷ This results in fewer evidentiary hearings or argu-

14. 15 U.S.C. § 78a (1982 & Supp. IV 1986).

15. 346 U.S. 427 (1953).

16. 15 U.S.C. § 77(a) (1982 & Supp. IV 1986).

17. See, e.g., NASD, CODE OF ARBITRATION PROCEDURE § 34 (1988) ("The arbitrators . . . shall not be bound by rules governing the admissibility of evidence.").

ment, and the receipt of more testimony from fewer witnesses.

3. *Finality*: Arbitration awards can only be challenged on the most extreme grounds,¹⁸ such as fraud or clear misconduct by the arbitrators. The result is that the uncertainty, delay, and expense of the appellate process is virtually eliminated in arbitration.

4. *Fairness*: No critic of arbitration has shown by statistics or otherwise that arbitrations are unfair to claimants. Express rules require that arbitrators be neutral and provide litigants with both peremptory challenges and challenges for cause. Testimony before the California Senate Commission by representatives of Charles Schwab & Co. and Dean Witter Reynolds suggested strongly that securities arbitration results in frequent awards to claimants.

III. PERCEIVED PROBLEMS

The critics of securities arbitration do, nonetheless, raise some significant issues. As discussed below, however, while worthy of close consideration, and possibly reform, these issues plainly do not justify abandonment of the system of mandatory arbitration.

A. *Bias of Arbitrators*

Without putting forward concrete evidence of any kind, the critics contend that securities arbitration panels are biased in favor of the brokerage houses. The rules require that arbitration panels in customer disputes be composed of a majority of members from outside the industry and provide for challenges. However, until recent reforms, retired securities professionals and attorneys regularly representing securities firms were considered "outside" panel members. Such practices have now been eliminated by adoption of more rigorous standards.¹⁹ The critics still contend that the panels from which arbitrators are selected for a particular case are unduly business-oriented and that a business and/or professional background of the arbitrators is unfair to lay customers. That has yet to be proven.

Indeed, there are persuasive counter-arguments. The business background of the arbitrators significantly reduces the time and expense of explaining the securities markets, complex transactions, and the internal procedures of large institutions. This expertise works to the advantage of both parties. More importantly, both experienced practitioners and arbitrators contend that securities arbitrators tend to view themselves as representatives of the regulatory authority sponsoring the panel. They see themselves charged with a duty to

18. See, e.g., Federal Arbitration Act, 9 U.S.C. §§ 2, 10, 11 (1982 & Supp. IV 1986); CAL. CIV. PROC. CODE § 1286.2 (West 1982).

19. See 48 Sec. Reg. & L. Rep. (BNA) No. 20, at 1847 (Dec. 9, 1987).

the public and profession of maintaining confidence in the integrity of the securities marketplace. They tend not to tolerate unfair or questionable practices.

There is little or no hard data available to refute either argument. It seems clear, however, that it would be a serious mistake automatically to equate the expertise and experience of arbitrators with bias. That unjustified conclusion would undermine one of the primary benefits of arbitration.

B. Discovery Limitations

Many critics of securities arbitration also focus on the very limited discovery available to the parties. Few litigators, however, would disagree with the characterization of judicial discovery as a two-edged sword. The costs are probably higher than any other pre-trial matter and the potential for harassment and delay is significant. Arbitration seeks to avoid these costs.

It does not, however, eliminate discovery. In both NYSE and NASD arbitrations, "the parties are encouraged to cooperate in the voluntary exchange of such documents and information as will serve to expedite the arbitration."²⁰ Where resistance is encountered, the arbitrators have power to order production of records from any member, firm or person.²¹ There are no provisions for pre-hearing depositions or interrogatories. As to third party discovery, the arbitrators have full subpoena power available "by applicable law."²²

Rarely do parties to an arbitration object to the absence of depositions or interrogatories. The most often heard complaint is that the securities firm has not produced significant documents or did so too late to permit full analysis of the materials by the customer's counsel. Such circumstances no doubt occur (as they do in judicial proceedings), although most arbitration cases seem to proceed without significant discovery disputes.

If problems concerning document production arise, they are remediable under existing rules. First, arbitrators almost always order the production of materials requested by a plaintiff when a good faith argument is made. If the order comes too late, a request for a delay in proceeding with the case can accompany the demand.²³

20. NASD, CODE OF ARBITRATION PROCEDURE § 32(b) (1988).

21. *Id.* § 33.

22. *Id.* § 32(a).

23. *Id.* § 30.

Because of its expense, many contend that it would seriously undermine the benefits of arbitration if the judicial sort of document discovery were to be permitted. There may, however, be room to assure that pre-hearing document exchanges are meaningful without being unduly burdensome. The arbitration rules could be amended to specify that a customer has a right to certain specific materials, such as new account records, account statements, order tickets, and the like. Each party should also have a right to see their adversary's expert reports or workpapers in advance of any such testimony. Another way that this could be handled would be by way of a pre-hearing conference held with the chair of the arbitration panel or with an arbitration counsel supplied by the arbitration sponsor, each of whom would be empowered to make such rulings.

Although discovery problems obviously arise in arbitration, as they do in any litigation, such problems appear solvable within the existing framework or through moderate reforms. They do not appear, however, to undermine the ultimate benefits of securities arbitration.

C Records and Reasons for Rulings

Arbitration panels presently are not required to state reasons for an award or make any findings of fact or rulings on legal matters. This procedure is considered by many to be an integral part of the efficiency and informality of arbitration because it permits a fast and efficient ruling by persons who are not lawyers or judges and need not be put to the test of couching their decision in legal terms. Unfortunately, the absence of explanation often results in a good deal of confusion and lack of satisfaction among the parties to the arbitration. As to customers, the absence of support or explanation for an award—particularly an award of less than they have requested—clearly tends to undermine their confidence in the fairness of the procedures.

The question of what to do about this issue is difficult, with no easy solution. Proponents of disclosure point not only to the absence of confidence engendered by the present system, but seek records of awards to use as "precedent" in later proceedings. Opponents of disclosure of more than the award itself, suggest that requiring any kind of findings or conclusions by the arbitration panel will have at least three undesirable effects: (1) increasing the burdens of arbitration counsel supplied by the regulatory sponsor or by counsel for the parties, who inevitably will have to write and propose such statements; (2) increasing the burdens on the arbitrators to express legal views and make evidentiary conclusions thereby discouraging some, particularly nonlawyer arbitrators, from serving; and (3) increasing the opportunity for judicial challenges to arbitration rulings.

Both NYSE and NASD have proposed to the Securities and Exchange Commission (SEC) that more information about awards be disclosed. The NASD has proposed making the amount of awards public, thereby providing some precedent, although protecting the arbitrators' names from disclosure.²⁴ The NYSE has proposed the use of an "award statement," which would include a summary of the dispute, description of the relief awarded, and a summary of other issues resolved.²⁵ Significantly, neither body has proposed that an explanation of the result or conclusion on the merits be prepared.

Given the importance of maintaining public confidence in arbitration, it would seem prudent to experiment with an appropriately qualified summary of the primary reasons for the award. The award preamble could state, for example, that the enclosed statement is made *not* to express legal conclusions or findings of fact, but only to express the general, lay view of the arbitrators concerning the dispute and is not intended to be used in any other proceeding.

While such a procedure raises the spectre of increased appeals and/or collateral proceedings in court, the limited grounds for appeal under the FAA and its state law counterparts²⁶ is likely to prohibit a significant increase in attempts to vacate the award even if some explanations are included. Thus, the risk of increased appellate proceedings may not be a real risk. If the procedure does result in problems, it can be eliminated or revised.

IV. LEGISLATIVE RESPONSE

In the face of organized lobbying, state legislators, unable to reform the procedural rules of NASD or NYSE, have focused on the "voluntariness" of arbitration. Bills or administrative rules to outlaw pre-dispute arbitration agreements have been proposed in several states. Legislators and other bill proponents note that, not unlike other arbitration agreements, securities arbitration agreements are often signed by customers at the time they open certain types of accounts at a brokerage house. The theory behind proposed legislation appears to be that claimants and their counsel should be permitted to choose between litigation and arbitration *after* a dispute arises rather than at the inception of a relationship with their broker. Such proposals would, if adopted, undermine the system of arbitration by

24. See *supra* note 19.

25. *Id.*

26. See *supra* note 18.

making it subject to the whims of either side during the heat of a dispute.

Whatever the merits of such reforms, state legislative efforts appear to be futile. Both the Supreme Court and the lower federal courts have consistently held that the Federal Arbitration Act preempts state laws that distinguish enforcement or interpretation of arbitration contracts from other contracts. In Massachusetts, the Secretary of State attempted to regulate pre-dispute securities arbitration agreements by issuing regulations effective January 1, 1989, defining "dishonest or unethical practices in the securities business" to include, *inter alia*, requiring customers to execute pre-dispute mandatory arbitration agreements as a "non-negotiable precondition" to doing business. The Massachusetts federal district court, however, in *Securities Industry Association v. Michael J. Connolly*,²⁷ held that by "establishing hurdles to the formation and execution of securities agreements that are not found in the general contract law of Massachusetts," the Massachusetts regulations conflict with the Federal Arbitration Act.²⁸

The California Legislature's experience foreshadowed the Massachusetts ruling. During California's consideration of legislation to either outlaw or limit pre-dispute arbitration, a compromise bill was introduced to require more stringent disclosures at the time of entering an arbitration contract. However, the California Legislative Counsel issued an opinion that such legislation would be preempted.²⁹ California's Senator Dan McCorquodale, who offered the disclosure legislation, subsequently withdrew his bill upon assurances that the regulatory authorities had committed to propose to the SEC adoption of more stringent disclosure requirements for future arbitration agreements.

V. CONGRESSIONAL ACTION

Pre-emption is, of course, no bar to action by Congress. The question at the national level therefore becomes not whether the Congress *can* act, but whether it *should* act. As explained above, it is by no means clear that mandatory arbitration should be disfavored. Indeed, longstanding federal policies on arbitration and industry self-regulation clearly support it. No evidence offered by critics of the system appears to justify a return to the option of judicial dispute resolution in the securities industry.

There is, however, another reason that Congress should defer—the expertise of the SEC. Congress set up the SEC, in part, to oversee

27. No. 88-2153-WD, slip op. (D. Mass) (Dec. 19, 1988).

28. *Id.* at 17.

29. Letter to Honorable Dan McCorquodale, April 26, 1988.

the securities markets and the self-regulatory bodies. The SEC has functioned adequately and, at times, vigorously, to protect public customers and maintain confidence in the public securities markets. The SEC opposes doing away with mandatory pre-dispute arbitration. Congress would be ill-served to ignore the SEC's views. Thus, for both substantive policy reasons and in deference to the SEC, Congress should stay its hand.

VI. CONCLUSION

For over a year now, securities industry disputes have been going to arbitration in record numbers. While pressure for reform remains strong, the source does not appear to be those who have been through the process or studied it extensively. Nor have statistics or other hard data been offered which justify reexamining the procedures currently in place. In this light, the furor over *McMahon* seems unjustified.

