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Rodriguez de Quijas v. Shearson/American Express, Inc.: Is Securities Arbitration Finally Above Suspicion?

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INTRODUCTION

The arbitration of securities disputes is not new. The New York Stock Exchange (NYSE) instituted a program to arbitrate member/nonmember disputes in 1872. Although arbitration agreements have a long history, they have gained new significance in recent years.

According to one commentator, "[s]ubstantially all customer margin account and option account agreements include provisions compelling future disputes relating to the account to be submitted to arbitration." The creation and implementation of these agreements is becoming more common. The number of arbitration cases increased nine hundred percent between 1980 and 1987, and approximately eighteen new disputes per day were submitted in 1988.

The importance of securities dispute arbitration is growing along with its frequency. At a time when broker-customer disputes are

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1 This arbitration program settled disputes between traders who were members of the NYSE and their customers.
2 Lipton, Broker-Dealer Regulation, 15 SEC. L. SERIES § 4.01(1), at 4-2 (1988).
4 Massachusetts Proposal Barring Mandatory Arbitration Clauses Debated, 20 SEC. REG. & L. REP. (BNA) 1219 (July 29, 1988) [hereinafter Massachusetts Proposal].
becoming more frequent, brokerage contract provisions specifying arbitral dispute resolution have met with increasing judicial approval. As a result, public investors may now find themselves airing their grievances in arbitration—a process that they are likely to believe is unfairly biased.

In May 1989, the Supreme Court in *Rodriguez de Quijas v. Shearson/American Express, Inc.* overruled a thirty-six-year old precedent, and held that predispute arbitration agreements are enforceable for claims brought by customers under the express right of action granted in the Securities Act of 1933. The decision harmonized inconsistent precedents regarding the enforceability of agreements for claims brought under the Securities Act of 1933 and the Securities Exchange Act of 1934.

Enforcement of predispute arbitration agreements raises concerns about investor protection, a recognized policy underlying the Securities Act. The need for such protection caused the Supreme Court in *Wilko v. Swann* to create a special exception to the Federal Arbitration Act (FAA). This exception allowed investors to unilaterally invalidate arbitration agreements and to have their disputes heard in federal court. Investor protection was a sufficiently important policy goal to prompt a specific exception to the general federal policy endorsing arbitration as a dispute resolution method. The Supreme Court, however, in *Rodriguez de Quijas*, comes full circle by endorsing arbitration as a protector of investor rights, thus precluding judicial remedies.

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6 See Ingersoll, *Sleepy Watchdogs*, Wall St. J., July 21, 1987, at 1, col. 6 (121% increase in complaints to the SEC from customers concerning brokers in 1986 as compared to 1982; 171% increase in same period for complaints to the NASD); Scheibla, *Big Decision—Can You Sue a Broker? High Court to Say*, Barron’s, March 2, 1987, at 32 (high rates of protests against brokers).


9 *Id.* at 1921.


16 See *Rodriguez de Quijas*, 109 S. Ct. at 1920.
This Comment assesses the impact of *Rodriguez de Quijas* and other contemporary changes on investor protection. Part I discusses the holding, rationale, and precedential importance of *Rodriguez de Quijas*. Part II examines the conflict between the FAA's promotion of judicial economy and expediency, and the investor protection purposes of the Securities Act and the Exchange Act. Part III addresses unique aspects of securities arbitration, including recent improvements and changes, in determining whether this system adequately protects investors. Finally, this Comment concludes that, while arbitration of securities disputes is fair and workable, it suffers from a poor public image. Arbitration's image must improve in order to perform the significant function of bolstering public confidence in the securities market by providing a swift and equitable procedure to resolve disputes.

I. THE *RODRIGUEZ DE QUIJAS* DECISION

A. Historical Background

1. Creation of the Wilko Exception

In 1953, the Supreme Court's decision in *Wilko v. Swann* created an exception to the FAA. *Wilko* involved a dispute between a customer and broker concerning fraudulent misrepresentations made in violation of the Securities Act. The Court held that the express right of action granted in the Securities Act should be protected by recourse to a judicial forum regardless of arbitration clauses contained in brokerage contracts. The exception, like others in the law, was based primarily on deficiencies in arbitration procedures. Although the *Wilko* Court addressed only claims

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17 *See infra* notes 20-66 and accompanying text.
18 *See infra* notes 67-112 and accompanying text.
19 *See infra* notes 113-211 and accompanying text.
21 *Id.* at 429.
22 *Id.* at 437.
24 These deficiencies included the lack of judicial review of the arbitrator's legal interpretations, the absence of written records or explanations of awards, and the imposed surrender of an investor's choice of venue. *See Wilko v. Swan, 346 U.S. 427, 432 (1953).*
brought under the Securities Act, other courts later used the investor protection rationale to enforce arbitration agreements brought under the implied rights of the Exchange Act and SEC Rule 10b-5.25

2. The Waning of the Wilko Exception

Over the past two decades, the Supreme Court has weakened the Wilko exception. In Scherk v. Alberto-Culver Co., a 10b-5 case arising from an international contract, the Court enforced an arbitration agreement.26 The need for predictability in foreign transactions and protection of the parties' expectations persuaded the court to validate the agreement in this context.27

By the mid-1980s, support within the Supreme Court for the enforcement of arbitration agreements increased. In Dean Witter Reynolds, Inc. v. Byrd, the Court rejected the intertwining doctrine, which extended pendent jurisdiction to arbitrable state law claims if sufficiently intertwined with non-arbitrable federal claims.28 No longer could parties block arbitration of state law claims by this method of forum selection.29 As one commentator stated, the denial of a federal judicial forum showed the Supreme Court's "strong predilection toward enforcing predispute agreements to submit disputes to arbitration."30 More significant, in Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, the Court rejected a "presumption against arbitration of statutory claims" absent contrary congressional intent.31 One author described Mitsubishi as recognizing the competence of arbitral tribunals "to determine complex disputes involving important issues of public

25 See, e.g., Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1030 (6th Cir. 1979) (arbitration agreements overriden by anti-waiver provision of federal securities laws); Sibley v. Tandy Corp., 543 F.2d 540, 543 (5th Cir. 1976), cert. denied, 434 U.S. 824 (1977) (claims under federal securities laws generally not subject to arbitration under preexisting arbitration clause); Ayers v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 538 F.2d 532, 536 (3rd Cir.), cert. denied, 429 U.S. 1010 (1976) (anti-waiver provision of Exchange Act prevents agreements to arbitrate further securities controversies); Greater Continental Corp. v. Schechter, 422 F.2d 1100, 1103 (2d Cir. 1970) (questions concerning fraud under Rule 10b-5 are properly litigated in court).
27 Id. at 516-17.
29 Id. at 217.
30 Bloomenthal, supra note 3, at § 8.30[2][a], 8-154.1.
These decisions reflect the growing confidence of the Court in the ability of arbitration to provide justice.

During this period, pressure mounted on lower courts to enforce arbitration clauses in brokerage contracts. In the last seven months of 1987, there were forty cases in which brokers attempted to enforce arbitration agreements. Although still the law, Wilko was losing vitality in some circumstances, particularly where the parties possessed equal bargaining power. One commentator stated that "courts generally [did] not apply the Wilko restraint . . . when it [was] clear that the parties [were] knowledgeable persons—for example, a sophisticated investor and a broker-dealer—and that the arbitration agreement was the result of an arm's length transaction."

The shifting policies of the Securities and Exchange Commission (SEC) during this period also heralded Wilko's waning power. SEC Rule 15c2-2, which took effect on January 1, 1984, made it illegal for brokers to create agreements purporting to bind customers to arbitration. The rule also required disclosure of unenforceability to customers who entered into agreements prior to adoption of the rule. The SEC designed Rule 15c2-2 to protect investor rights, yet, within four years of its enactment, the rule was repealed as no longer appropriate in light of case law development. By 1987, the SEC reversed its position on predispute agreements, and argued for their enforcement. Due to expansions in its oversight authority, the Commission advocated dispute arbitration through self-regulatory organizations (SROs).

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33 See Bloomenthal, supra note 3, at 8-154.1.


36 Id.


39 See infra notes 140-53 and accompanying text.
3. Shearson/American Express, Inc. v. McMahon: The Creation of Inconsistency

The Supreme Court laid the theoretical foundation for Rodriguez de Quijas several years earlier. In 1987, the Court decided Shearson/American Express, Inc. v. McMahon, a controversial decision that departed from the Wilko exception. Affirming its resolve that arbitration was an effective protector of investor rights, the Court held that claims brought under the 1934 Securities and Exchange Act did not require judicial resolution. The Court based its conclusion on improvements in arbitration, expanded SEC oversight of SRO arbitration procedures, and the lack of a clear congressional intent to restrict securities claims to a judicial forum. This ruling, however, was limited to claims brought under the Exchange Act. Thus, McMahon created an inconsistency; the Court would enforce arbitration agreements under the Exchange Act but not under the Securities Act.

4. Rodriguez de Quijas and the Death of the Wilko Exception

On May 15, 1989, the Supreme Court decided Rodriguez de Quijas v. Shearson/American Express. On facts "identical to Wilko," the Court held that the "special" right of action granted by the Securities Act did not need the protection of a judicial forum, and that arbitration agreements are enforceable for claims brought under either act.

In addition, the Court expressly stated that Wilko was incorrectly decided. The Court overruled Wilko, finding it to be "inconsistent with the prevailing uniform construction of other

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40 482 U.S. 220 (1987). This case involved alleged fraudulent conduct by a retail broker who invested a private pension fund, as well as personal funds, for a funeral home director.

41 Id. at 238.
42 Id. at 232.
43 Id. at 233-34.
44 Id. at 234-35.
45 Id. at 233-36.
47 Bloomenthal, supra note 3, at § 8.30[2][c], 8-154.8.
48 See infra note 86.
50 Id.; see also infra notes 120-24 and accompanying text.
federal statutes governing arbitration agreements in the setting of business transactions."\textsuperscript{51}

B. \textit{The Probable Longevity of Rodriguez de Quijas—the Supreme Court and Precedents of Statutory Interpretation}

According to one scholar, the current Court faces a "conservative paradox."\textsuperscript{52} The conservative philosophy of cautious movement works against activism and makes it less likely that the Court will reverse important decisions of the past.\textsuperscript{53} The force of the conservative paradox indicates that once a judicial move is made, the Court will tend to adhere to its interpretation.\textsuperscript{54}

The Supreme Court will overturn its own precedents only if they do not "state the correct rule of law."\textsuperscript{55} While the Court has the exclusive power to overrule its own decisions,\textsuperscript{56} the need for correction must be balanced against the goal of consistent and predictable application of the law.\textsuperscript{57}

Contemporary cases illustrate what the Court requires to overturn a statutory interpretation precedent. In \textit{Patterson v. McLean Credit Union},\textsuperscript{58} the Court outlined the greater "burden borne by the party advocating the abandonment of an established precedent . . . of statutory construction," that unlike constitutional interpretation, may be altered by Congress.\textsuperscript{59} In deciding whether to overrule precedents of statutory interpretation, the Court applies a three-part test that examines whether the decision has been undermined by subsequent changes or legal developments, whether the rule of law is unworkable, and whether the decision poses an obstacle to objectives embodied in other statutes.\textsuperscript{60}

Although at least one commentator has questioned the volatility of Constitutional interpretations in recent decades,\textsuperscript{61} statutory

\textsuperscript{51} 109 S. Ct. at 1922.
\textsuperscript{53} \textit{Id}.
\textsuperscript{54} \textit{Id}.
\textsuperscript{55} \textit{See} Girouard v. United States, 328 U.S. 61, 69 (1945).
\textsuperscript{56} \textit{See} Thurston Motor Lines, Inc. v. Jordan K. Rand, Ltd., 460 U.S. 533, 535 (1983); \textit{see also} Rodriguez de Quijas, 109 S. Ct. at 1923 (Stevens, J., dissenting) (Court not subject to restraints placed on courts of appeals in upsetting own precedents).
\textsuperscript{58} \textit{Id.} at 2370.
\textsuperscript{59} \textit{Id.} at 2370-71.
interpretation precedents such as Rodriguez de Quijas are less likely to change. In Rodriguez de Quijas, the Court spoke of its "normal and proper" reluctance to overturn decisions construing statutes. Apparently, the Court believed that the respondents in Rodriguez de Quijas carried the greater burden required to abandon an established statutory interpretation. Developments in arbitration undermined the rationale of the Wilko exception. The differing treatment of claims under the 1933 and 1934 Acts after McMahon proved unworkable, leading to concerns regarding "manipulation of allegations" to secure a desired forum. Finally, the divergent treatment of claims under the two acts "undermine[d] congressional policy as expressed in other legislation."

The Court in Rodriguez de Quijas moved in apparent harmony with its current holdings to overturn Wilko and achieve a uniform interpretation of two similar statutes. Absent affirmative Congressional action to the contrary, one may reasonably expect that predispute arbitration agreements will be enforceable for some years to come.

II. INVESTOR PROTECTION VS. THE JUDICIAL ECONOMY OF ARBITRATION

A. Arbitration

1. Enactment of the FAA: Policy Goals

The development of arbitration as a means of alternative dispute resolution has been hindered by "centuries of judicial hostility to arbitration agreements." In 1925, Congress enacted the Federal Arbitration Act (FAA) "with the express intent of erasing the traditional judicial hostility toward arbitration, and of compelling judicial enforcement of arbitration agreements."

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62 109 S. Ct. at 1922.
63 Id. at 1921.
64 Id. at 1920.
65 Id. at 1922.
66 Id.
In statutory language that is a "model of clarity and simplicity,"\textsuperscript{70} the FAA advances the federal goal of promoting arbitration. The FAA is designed to allow judicial enforcement of all arbitration agreements. Under the Act, agreements are enforceable as contracts, and may be specifically enforced in the absence of controversy surrounding the creation of or compliance with the agreement.\textsuperscript{71} Moreover, any doubts regarding the arbitrability of issues must be resolved in favor of arbitration.\textsuperscript{72}

The policy goals supporting the FAA are as clear and simple as the language of the act itself. After years of hostility, courts now recognize the potential benefits of arbitration, both to the parties and to the courts.\textsuperscript{73} The FAA raises arbitration agreements to the level of enforceable contracts, thereby promoting arbitration and its benefits. According to several authors, "the Arbitration Act simply codifies the common law duty of courts to enforce the terms of valid contracts, and was necessitated only by the traditional reluctance of courts to enforce arbitration clauses."\textsuperscript{74}

Thus, the FAA promotes a policy that was perceived to be at odds with that of securities regulations: the promotion of efficiency, speed, and economy rather than the protection of investors' statutory rights.

B. Securities Regulation: Designed to Protect Investors

1. Policies Supporting the Securities Act and the Exchange Act

In most broker-customer disputes, public investors seek to enforce rights granted under either the Securities Act or the Exchange Act.\textsuperscript{75} To analyze properly the effects of *Rodriguez de

\textsuperscript{70} Bedell, Harrison, & Grant, Arbitrability: Current Developments in the Interpretation and Enforceability of Arbitration Agreements, 13 J. Contemp. L. 1, 3 (1987).


\textsuperscript{74} Bedell, Harrison & Grant, supra note 70.

\textsuperscript{75} Both acts provide protection to the investing public through prohibition of fraudulent acts by brokers. See infra notes 76-106 and accompanying text; see also N. Wolfson, R. Phillips, & T. Russo, Regulation of Brokers, Dealers, and Securities Markets ¶ 2.01 (1977).
Quijas, one must examine the purposes of these two regulatory acts in order to determine whether their implicit goals require disparate treatment of arbitration agreements for actions to enforce the rights granted by their provisions.

The purposes and provisions of the 1933 Securities Act are unquestionably different from those of the 1934 Exchange Act. Congress designed the Securities Act to protect the investing public by regulating dealers, underwriters, and issuers of securities. On the other hand, the Exchange Act’s “primary focus [is] . . . on the creation and maintenance of an efficient and orderly capital market.” Its provisions deal principally with securities trading after public distribution. Although their areas of regulation are different, the two Acts have at least one common goal—the protection of investors.

Investor protection is such an important purpose of the Securities Act that its provisions create an express right of action for public investors. As part of its protective mechanism, the Act requires that the defendant show lack of scienter. Furthermore, the Act provides for lowered amount in controversy requirements and concurrent jurisdiction without removal to the federal courts. On the other hand, the investor rights of action

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78 A dealer is one who engages in the business of buying and selling securities for his own account. See 15 U.S.C. § 77b(12).
79 An underwriter is one who buys securities from an issuer and/or participates in the distribution of those securities to the public. See 15 U.S.C. § 77b(11).
81 See Comment, supra note 69, at 625.
83 See 78 Cong. Rec. 2264 (1934) (message from President Roosevelt) (The Securities Act was “but one step in our broad purpose of protecting investors and depositors”; the Exchange Act was enacted “for the protection of investors”).
84 Any person who violates the provisions of the act “shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction.” 15 U.S.C. § 77l(2).
85 Id.
87 Id.
provided under the Exchange Act are judicially implied.\textsuperscript{88}

Although the statutes have similar goals, the different sources of public rights of action raise controversy about the need for differing treatment of arbitration agreements.\textsuperscript{89} The desire to protect investors resulted in nonenforcement of arbitration agreements for claims brought under the Securities Act’s express right of action.\textsuperscript{90} On the other hand, \textit{McMahon} required the opposite result for arbitration claims brought under the Exchange Act’s implied right of action.\textsuperscript{91}

This inconsistent treatment proved problematic. Substantial judicial authority indicates that, despite differences in their provisions, the two acts are interrelated components of the same federal regulatory scheme.\textsuperscript{92} The Court in \textit{Rodriguez de Quijas} questioned the manipulation of claims by customers if the Acts were not construed alike.\textsuperscript{93} As one court stated in a post-\textit{Rodriguez de Quijas} decision, “[d]ivergent treatment of . . . controversies would lead to arbitrary and inefficient results.”\textsuperscript{94}

The Court resolved the inconsistency caused by \textit{McMahon} by holding that the enforceability of arbitration agreements no longer...
depends upon the nature of the rights enforced.\textsuperscript{95} This analysis directly parallels the interpretation provided by the SEC. In its amicus curiae brief filed in \textit{McMahon}, the SEC argued that any distinction between express and implied rights is irrelevant to enforceability, and that attempts to draw such distinctions could impair investor protection.\textsuperscript{96} According to the Commission, the crucial factor is the voluntary nature of the agreement.\textsuperscript{97} Rather than concentrating on the nature of the rights involved, the SEC interpretation examines the agreement as a contract.\textsuperscript{98} At least one court followed this reasoning and found any distinction between express and implied rights of action meaningless.\textsuperscript{99}

The effectiveness of a contract-based analysis of arbitration agreements is borne out by the nature of the disputes that typically arise. Controversy surrounding enforcement of arbitration agreements largely centers on predispute agreements.\textsuperscript{100} Post-dispute agreements\textsuperscript{101} have long been held enforceable,\textsuperscript{102} due in part to their more voluntary nature. By analyzing post-dispute agreements as contracts, the courts harmonize interpretations of the 1933 and 1934 acts as a unified regulatory scheme. Contract law principles such as unconscionability,\textsuperscript{103} fraudulent inducement,\textsuperscript{104} and mistake\textsuperscript{105} have been applied to arbitration agreements as a whole,\textsuperscript{106} and a focus on the mutual agreement of the parties provides a more correct analytical framework for examining the enforceabil-

\textsuperscript{95} 109 S. Ct. at 1922.
\textsuperscript{97} SEC Brief to \textit{McMahon}, supra note 38, at 24.
\textsuperscript{98} \textit{Id.}
\textsuperscript{100} See 346 U.S. at 438.
\textsuperscript{101} The parties enter into these agreements after a dispute arises.
\textsuperscript{103} See generally E. FARNSWORTH, CONTRACTS 307-316 (1982).
\textsuperscript{104} See generally \textit{id.} at 235-36.
\textsuperscript{105} See generally \textit{id.} at 670.
ity of arbitration agreements for claims brought under either of the two acts.

The 1933 and 1934 acts do not require different treatment of claims. A unified interpretation for enforcement of arbitration agreements produces results that are more logical and consistent. The goal of investor protection is thus fulfilled by analysis of the disputes as issues of contract law.

2. Analogous Investor Protection

The need for investor protection resulted in a long history of special treatment of securities disputes. Courts have treated arbitration agreements between brokers and customers differently from similar agreements that are unrelated to the securities industry. The goal of investor protection led not only to decisions limiting the enforceability of arbitration agreements, but also to the creation of special protective mechanisms in other, broader areas of securities regulation.

The parties in public securities transactions usually do not possess equal bargaining power. In order to protect investors in uneven exchanges, the definition of securities fraud differs from the common-law definition. Securities brokers are liable for active misstatements and are charged with affirmative duties to disclose material information in their possession. Congress and the judiciary created private rights of action for the investing public not only to provide a remedial pathway for the investor, but also to serve a larger public function. Private suits are "an effective and indispensable supplement to the 'policing' of the federal securities laws." With the individual's power to bring suit to enforce public laws, the investor becomes a private attorney general. Private suits are "a necessary supplement to

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107 See, e.g., Wilko, 346 U.S. 427 (arbitration insufficient to protect investor rights); Moore, 590 F.2d 823 (implied extension of Wilko doctrine to Exchange Act claims); Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 558 F.2d 831 (7th Cir. 1977) (protection of investors needed due to unequal bargaining power).

108 These mechanisms include an expanded definition of fraud, prohibitions against insider trading, and standards of conduct for dealing with customers. See generally N. Wolfson, R. Phillips & T. Russo, supra note 75, at 2-1 - 2-90.

109 Courts base the duty to disclose on two foundations: the so-called "shingle" theory, which posits that brokers who hang out their shingles to the public represent that they will deal fairly and honestly, and the fiduciary relationship theory. See id. at ¶ 2.03.


111 H. Bloomenthal, supra note 88, at § 11.01.
[SEC] enforcement” of securities laws. Thus, the goal of investor protection is enhanced by allowing public and private deter-
rence.

III. Does the Current Scheme of Enforcement of Arbitration Agreements Provide Sufficient Protection for Investors?

A. Investor Protection vs. Public Mistrust of Arbitration

Courts recognize that investor protection is a goal of securities laws in general, and the Securities Act in particular. The need for protection arises in part from the likelihood of conflicts of interest. As one court stated, “‘[t]here is a potential for conflicts of interest when an investor’s marketplace intermediary . . . has one unilateral adversarial eye cocked upon possible litigation between the parties to a standardized brokerage contract.’” Conflicts are inherent in today’s securities market; they are produced in part by the brokerage industry’s compensation structure.

Changes in market conditions such as the growth of program trading and derivative instruments have hurt the small investor. Even in the face of such conflicts, the Supreme Court plainly indicates that the goal of investor protection is reached.

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115 See generally 1 S. GOLDBERG, FRAUDULENT BROKER-DEALER PRACTICES § 2.2[a] (1978) (system of broker compensation based on commission generated for firm creates clearest imaginable conflict of interest).
116 Program trading involves the use of automation to order purchases or sales as certain stocks or market indexes attain pre-specified levels.
117 Derivative instruments are traded securities, such as option contracts, which derive their value from the price of the underlying security.
through arbitration, an "avenue of relief ... in harmony with the Securities Act's concern to protect buyers of securities."119

The Court's reasoning in Shearson/American Express, Inc. v. McMahon120 and its progeny is based largely on increased judicial acceptance of arbitration as a means of protecting investors: "the heart of the Majority opinion focuses on the arbitration process and the substantial improvements made to it since the Wilko decision in 1953."121 The "suspicion of arbitration"122 that formed the basis of Wilko v. Swann123 is far from the contemporary endorsements of arbitration statutes.124

Yet public opinion does not support the Court's judgment.125 Mistrust by the investing public is at the center of controversy surrounding predispute arbitration agreements.126 The suspicion still harbored by investors is a significant problem in securities arbitration. Prejudice against arbitration harms public confidence in the securities markets.127 The perception of unfairness, however unjustified, prevents arbitration from being an accepted method of securities dispute resolution.128

Evidence does not indicate that arbitration is unfair. The results of arbitrations are the best indication of fairness. A biased and unfair system should produce awards that favor the brokerage houses, or that are unjustifiably small. If a few recent awards are illustrative, at least some investors are faring well under arbitra-

121 Comment, supra note 32, at 567-68.
122 Rodriguez de Quijas, 109 S. Ct. at 1920.
124 Rodriguez de Quijas, 109 S. Ct. at 1921.
127 See Fletcher, Privatizing Securities Disputes Through the Enforcement of Arbitration Agreements, 71 Minn. L. Rev. 393, 460 (1987).
128 See Katsoris, supra note 34, at 310; Note, supra note 23, at 545-49.
According to information provided by the American Arbitration Association (AAA) in 1987, of the last forty disputes resolved by that organization, twenty-seven (sixty-eight percent) resulted in awards to customers, including four instances of punitive damages.

The ability to award punitive damages works in favor of the customer. While some state courts bar punitive damages in arbitration, federal courts allow such awards if they are specified in the arbitration agreement.

Protection of investor confidence, perhaps the most vital function of securities regulation laws, must therefore be addressed through improvements to the arbitral process. Arbitration must preserve speed and economy without sacrificing fairness and completeness. Any changes in arbitration must take these factors into account, with fairness being the primary element in order to protect public faith in the process.

B. Investor Protection and Unique Aspects of Securities Arbitration

1. Procedural Features

SEC concerns about the procedural aspects of SRO arbitration have been present for at least the last several years. According to one author who shares similar concerns,

129 For descriptions of recent substantial awards favorable to customers, see Shearson-Lehman Loses $3.1 Million NASD Case, Today's Investor, July 7, 1989, at 2; Areddy, Shearson Lehman, Paine Webber Told to Pay Big Awards, Wall St. J., May 25, 1989, at C9 col. 3; see also NYSE Proposes Highlighting Rights, Providing Summary Data on Arbitrations, 20 Sec. Reg. & L. Rep. (BNA) 1783 (Nov. 23, 1988) [hereinafter NYSE Proposes Highlighting] (NYSE survey indicates arbitration is significantly quicker, less expensive, and results in customer awards significantly higher than those obtained in litigation); Massachusetts Proposal, supra note 4 (study of cases involving Dean Witter Reynolds indicates higher rate of customer recovery for arbitrated disputes).


133 Katsoris, supra note 34, at 370-71.

134 SEC Staff to Urge Revisions to Industry Arbitration System, 19 Sec. Reg. & L. Rep. (BNA) 1387 (Sep. 18, 1987) [hereinafter SEC Staff to Urge].
the arbitration system provides minimal assurance that an arbitrator will act properly and fairly when deciding a securities issue. By contrast, in litigation the investor has an established procedure and right to challenge judicial actions and decisions. This insures that the twin objectives of justice and investor protection are consistently being accomplished.\footnote{Comment, supra note 32, at 573.}

One SEC official, while characterizing arbitration as the best method of dispute resolution for most customers, listed litigation advantages as rational reasons why customers would refuse a predispute agreement.\footnote{SEC Tables Proposal to Bar Brokers From Mandating Predispute Agreements, 20 Sec. Reg. & L. Rep. (BNA) 832 (June 3, 1988) [hereinafter SEC Tables Proposal] (quoting SEC Division of Market Regulation Director Richard Ketchum).} Despite these views, there are compelling arguments that arbitration's simplified procedures and limited discovery are advantageous to customer-plaintiffs.\footnote{Customers may find that arbitration's lack of strict pleading requirements for fraud protects their ability to bring actions. See Fletcher, supra note 127, at 453-54; Hood, Arbitration and Litigation of Public Customers' Claims Against Broker-Dealers After McMahon, 19 St. Mary's L.J. 541, 581-85 (1988); see also Note, Pleading Securities Fraud Claims With Particularity Under Rule 9(b), 97 Harv. L. Rev. 1432 (1984) (increasing frequency of dismissal of investor claims under Federal Rule of Civil Procedure 9(b)).}

Securities dispute arbitrations usually proceed along similar lines, regardless of the presiding organization.\footnote{See generally Katsoris, supra note 34, at 283-84 (discussing history of Uniform Code of Arbitration in 1976).} SRO procedures follow the Uniform Code of Arbitration, drafted by the Securities Industry Council on Arbitration (SICA).\footnote{Bloomenthal, supra note 3, at § 8.30[2][g], 8-154.18.} The NYSE and American Exchange (AMEX)\footnote{SEC Staff to Urge, supra note 134.} have adopted the Uniform Code of Arbitration while the National Association of Securities Dealers (NASD), the largest conductor of SRO arbitrations,\footnote{See generally Bloomenthal, supra note 3, at § 8.30[2][g], 8-154.18 (provisions and features of NASD Code of Arbitration Procedure discussed).} follows procedures based on the Uniform Code and the FAA.\footnote{Lipton, supra note 2, at § 4.02[4][a], 4-16.}

Third parties such as the AAA may also conduct dispute resolution.\footnote{Id.} This avenue of arbitration, called for by some agreements,\footnote{Id.} is designed to be "more independent of the securities..."
industry than arbitration carried out by the securities exchanges."\textsuperscript{145}

Federal securities laws undoubtedly apply in arbitration. Furthermore, the AAA contends that in the years since \textit{Wilko}, the courts have developed a body of securities case law to which arbitrators can, and do, refer.\textsuperscript{146} However, the law may not play the primary role in arbitration that it does in the judicial process.\textsuperscript{147} One commentator even suggests that arbitrators might base their decisions on grounds other than legal rules.\textsuperscript{148} Although the relationship between the law and arbitration is beyond the scope of this Comment, one need not conclude that decisions based on an arbitrator's ideas of commercial fairness would be prejudicial per se to customers.

Attempted revisions of the arbitration system must balance the speed and economics of current practices against the possibility of efficiency lost by improvements.\textsuperscript{149} Limited discovery is one of arbitration's most attractive features due to potential cost savings. Even though discovery is less thorough in arbitration than in court proceedings,\textsuperscript{150} arbitration discovery can include the use of subpoenas of persons and documents as state law permits,\textsuperscript{151} orders of appearance, and production of documents held by SRO members and their employees.\textsuperscript{152} Additionally, the rules of the NYSE now provide sanctions for failure to produce documents within ten days of the request. The failing party is not allowed the use of documents not delivered to the requesting party.\textsuperscript{153}

\textsuperscript{146} AAA Brief to McMahon, supra note 130, at 14.
\textsuperscript{149} Lipton, supra note 2, at § 4 app. 4.01, 4-27.
\textsuperscript{150} See Katsoris, supra note 34, at 287 n.52.
\textsuperscript{152} NYSE Rules § 638, 2 N.Y.S.E. Guide (CCH) ¶ 2628, at 4321 (March, 1989).
\textsuperscript{153} NASD CAP § 33, NASD Manual (CCH) ¶ 3733, at 3720 (April, 1988); NYSE Rules § 620, 2 N.Y.S.E. Guide (CCH) ¶ 2620, at 4320 (Feb., 1989).
A 1987 study funded by the National Institute for Dispute Resolution found that the most common criticism of the arbitration discovery process concerns delay in production or nonreceipt of documents. The study concluded that SRO staff attorneys need to enforce discovery timetables and encourage cooperative agreements among the parties. If noncompliance with existing procedures is the major problem facing the discovery process, then sanctions such as those imposed by the NYSE are necessary improvements.

Some suggest that codifying existing informal SRO practices, such as allowing involvement of arbitrators in discovery disputes before the first hearing, would improve arbitration and outweigh the additional costs and time involved. The SICA proposed similar rules well before the McMahon decision. Movement toward codification demonstrates industry recognition of needed reforms.

Under the traditional system, judicial review of an arbitrator’s decision is impaired because of the absence of concrete hearing records. The lack of transcripts may prevent accurate judicial assessment of factual errors, or detection of unfairness in the proceeding. Arbitrators already have taken the first steps toward rectifying this problem. Some SRO arbitration procedures now require that stenographic or taped records be kept of all hearings.

Another serious criticism is that courts and investors cannot review the reasoning behind an arbitral decision because there are no written opinions. This will change, however, with new SRO rules approved in May, 1989 by the SEC. Pursuant to the changes, summarized one-page award statements of arbitrations will be

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154 Lipton, supra note 2, at § 4.03[1][2], 4-23-25.
155 Id.
156 Katsoris, supra note 82, at 372.
157 Id. at 372 n.75.
158 See Comment, supra note 32, at 571-72.
159 The Federal Arbitration Act does not require written records of arbitration proceedings to be kept. See 9 U.S.C. §§ 1-14 (1982).
available to the public for the first time.\textsuperscript{162} The utility of these statements is unknown, however, since they will be unpublished but available to the public at each individual SRO's Public Reference Room.\textsuperscript{163}

The statements will conform to a model promulgated by the SEC, and will include the following elements:

- the name of the arbitration case; [a] one-paragraph summary of the dispute; damages or other relief requested; damages or other relief awarded; a one-paragraph summary of other issues resolved (for example, the arbitrators might rule that they do not have jurisdiction over a respondent and state that they will not consider the allegations against the respondent); and names of the arbitrators.\textsuperscript{164}

Statements issued by the NASD will not include arbitrator names, but customers facing pending arbitration will be able to obtain past decisions of the arbitrators involved in their dispute.\textsuperscript{165}

These changes faced some opposition within the industry. The Securities Industry Association (SIA) contends that these summaries "will in no way help investors."\textsuperscript{166} The SIA argues that the lack of uniformity in the summaries, diversity in the types of claims reported, and the unique nature of each case, as well as the "bargaining process" arbitrators sometimes engage in to reach their consensus decisions, may hinder the investing public's ability to evaluate arbitration in general and specific arbitrators in particular. Ultimately, only time and additional disputes will tell if these changes will provide customers with anything other than psychological comfort.

\textsuperscript{162} SEC Approves Arbitration Summaries, Other Revisions to Industry Programs, 21 Sec. Reg. & L. Rep. (BNA) 683 (May 12, 1989) [hereinafter SEC Approves Arbitration Summaries].

\textsuperscript{163} Id.


\textsuperscript{165} SEC Approves Arbitration Summaries, supra note 162.

2. Self-Regulatory Nature

The SEC\textsuperscript{167} and the Supreme Court\textsuperscript{168} have used the expanded enforcement powers granted to the SEC by 1975 amendments to the Exchange Act\textsuperscript{169} to justify the increased acceptance of securities dispute arbitration. These amendments gave the Commission substantially expanded authority to oversee the rules of the SROs as well as the national exchanges.\textsuperscript{170} But reliance on the SEC's ability to protect investors is not universally accepted. Time delays inherent in the Commission's procedures,\textsuperscript{171} staff shortages, and an excessive caseload\textsuperscript{172} raise doubts about the quality of supervision. In addition, the case-by-case scrutiny this oversight requires may exceed the scope of the Commission's powers.\textsuperscript{173}

The arbitrator's ability to comprehend complex securities issues and to reach fair settlements is also questioned\textsuperscript{174} because he or she must understand both the law and the securities market. This concern is perhaps overstated when examined in light of AAA statistics.\textsuperscript{175} Eighty percent of AAA arbitrators came from the legal field, including a significant number of securities practitioners and judges, while another eighteen percent had backgrounds as business, financial, or accounting executives. SRO arbitration programs show a similar preference for attorneys as public and industry arbitrators.\textsuperscript{176} The predominance of attorneys in arbitration panels suggests that securities regulation law is correctly understood and applied by arbitrators. Based on their legal knowledge and business expertise, one may reason that arbitration panels possess the requisite abilities to reach proper decisions.

\textsuperscript{167} SEC Brief to McMahon, supra note 38.
\textsuperscript{168} Rodriguez de Quijas, 109 S. Ct. at 1920.
\textsuperscript{169} S. 249, 94th Cong., 1st Sess. (1975).
\textsuperscript{170} See generally N. Wolfson, R. Phillips & T. Russo, supra note 75, at ch. 12 (self-regulation examined); Katsoris, supra note 34, at 283-84 (relationship between SEC and SRO arbitration programs described).
\textsuperscript{171} See Proposed NYSE Arbitration, supra note 161.
\textsuperscript{172} See Brief for the Respondent at 30-34, Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987) (86-44); Ingersoll, supra note 6.
\textsuperscript{173} See Case Note, supra note 166, at 816-17.
\textsuperscript{174} See Cobb v. Lewis, 488 F.2d 41, 47 (5th Cir. 1974); Power Replacements, Inc. v. Air Preheater Co., 426 F.2d 980, 984 (9th Cir. 1970); American Safety Equip. v. J.P. Maguire & Co., 391 F.2d 821, 826 (2d Cir. 1968).
\textsuperscript{175} AAA Brief to McMahon, supra note 130, at 14 (statistics based on forty AAA arbitrations preceding McMahon).
\textsuperscript{176} For statistics on arbitrator pool composition for NYSE and NASD arbitration programs, see Lipton, supra note 2, at § 4 app. 4.01, 4-41.
Aside from individual arbitrator competence, the composition of arbitration panels bears on the fairness of the proceedings. In NASD arbitrations, the panel is appointed by the NASD Director of Arbitration, who appoints either three or five arbitrators if the amount in controversy is less than thirty thousand dollars. Five arbitrators are appointed if the amount exceeds that figure.\(^{177}\) In either case, unless the customer requests otherwise, the majority of panelists cannot be from the securities industry.\(^{178}\)

Recent changes to SRO programs expand the definition of "industry" arbitrators to include any person associated with an SRO member or other securities-related entity for three years, anyone retired from a member organization or similar business, or any lawyer, accountant, or other professional who has devoted twenty percent or more of his or her work effort to industry clients in the last two years, as well as the household members of an associated person.\(^{179}\) To further guarantee fairness, each party has one peremptory challenge, and others may be awarded for cause by the Director of Arbitration.\(^{180}\) Given the apparent qualifications of arbitrators and the restrictions placed on their securities industry ties, one may reasonably conclude that arbitrators are unbiased and competent to handle disputes.

C. Arbitration and the Future

Legal scholars level meaningful criticisms at the securities arbitration process.\(^{181}\) Some argue that securities case law may stagnate as more disputes are settled through arbitration,\(^{182}\) and that litigation deters broker wrongdoing.\(^{183}\) Other criticisms include

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177. NASD CAP § 19, NASD Manual (CCH) ¶ 3719, at 3716 (Jan., 1989); NASD Proposed Public Awards Disclosure as Part of Arbitration Program Revision, 20 Sec. Reg. & L. Rep. (BNA) 1847 (Dec. 9, 1988). See generally Lipton, supra note 2, at § 4 app. 4.01, 4-34 - 4-51 (selection and classification of arbitrators); Katsoris, supra note 82, at 376-80 (training, classification, and selection of arbitrators).

178. NASD CAP § 19, NASD Manual (CCH) ¶ 3719, at 3716 (Jan., 1989).


181. See supra notes 134-80 and accompanying text.

182. See Case Note, supra note 166, at 816-17; Note, supra note 23, at 574.

concerns over arbitrator conflicts of interest, biased composition of arbitration panels, limited review of decisions, limited discovery, and a sense of inherent unfairness in the proceedings. There are reasons to believe that public concerns are being addressed.

Recent "potentially far-reaching changes to industry arbitration programs" have been instituted. As a result of extended discussion by the members of SICA, one change "require[s] that broker-dealers highlight and explain customers' rights" under mandatory arbitration agreements. In addition, improved discovery procedures, and redefinition of "industry" member arbitrators give the securities arbitration process a more open image, and therefore inspire public confidence in the market. Similar improvements in arbitration procedures are taking place in other areas of the investment industry. Even though the success of these improvements is not guaranteed, they can help change negative public attitudes toward arbitration, and make it an effective means of dispute resolution and investor protection.

The tremendous growth in securities arbitration over the last decade also has prompted a concern that practice in unfamiliar arbitral forums by litigation-oriented attorneys reduces the quality of client representation. At least one scholar suggests that this is not problematic because securities practitioners emphasize substantive law in arbitration proceedings. Others argue that, due

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184 See supra notes 113-19 and accompanying text.
185 See supra notes 176-80 and accompanying text.
186 See supra notes 158-61 and accompanying text.
187 See supra notes 149-57 and accompanying text.
188 SEC Approves Arbitration Summaries, supra note 162; see also NASD Proposes, supra note 179 (proposals to improve and streamline arbitration process); NYSE Proposes Highlighting, supra note 129 (proposed changes to arbitration process to meet criticisms that mandatory arbitration agreements are unfair to customers).
189 SEC Approves Arbitration Summaries, supra note 162.
190 The SICA consists of representatives from the NASD, the national exchanges, and the Municipal Securities Rulemaking Board, along with four public representatives. See Bloomenthal, supra note 3, at § 8.30[2][k], 8-154.34.
191 SEC Approves Arbitration Summaries, supra note 162.
192 See supra notes 150-57 and accompanying text.
193 See supra notes 174-80 and accompanying text.
194 See CFTC Staff to Recommend CFTC Limit Role of Sanctioned Exchange Members, 21 Sec. Reg. & L. Rep. (BNA) 859 (June 9, 1989) [hereinafter CFTC Staff to Recommend] (Commodities Futures Trading Commission staff considering changes in futures arbitration similar to those approved by the SEC).
195 See supra note 5.
to experience in presenting cases to an uninformed jury, even seasoned litigators may be at a disadvantage when dealing with sophisticated arbitrators.\textsuperscript{197} In either case, law schools must begin to prepare their graduates for arbitration practice.\textsuperscript{198}

The enforceability of arbitration agreements depends on voluntary assent by the parties.\textsuperscript{199} The type of customer account involved has a significant bearing on whether an arbitration agreement is required in a brokerage contract. According to one SEC official, only thirty-nine percent of cash accounts involve mandatory predispute arbitration clauses, and five of the largest brokerage firms do not require arbitration agreements from their cash account customers.\textsuperscript{200} In contrast are earlier SEC comments concerning customer ability to enter the market without an arbitration agreement. In 1988, an SEC Division of Market Regulation staff survey indicated a "growing broad-based trend towards requiring predispute arbitration agreements for cash accounts,"\textsuperscript{201} and the refusal of brokerage houses to waive such agreements for "normal retail customers."\textsuperscript{202}

Mandatory arbitration agreements cause concern about the fairness of the system to the average customer. The willingness of brokerage houses to waive the same requirements for institutional investors is described as "unfair to small investors."\textsuperscript{203} Indeed, concern over mandatory arbitration agreements has resulted in legislative action on the state level.\textsuperscript{204} In contrast, one industry executive argues that mandatory predispute arbitration agreements do not deny margin access to those unwilling to arbitrate, as his firm requires only margin and option account customers to sign such agreements. The seventy-eight percent of customers who

\textsuperscript{198} Id. at 1405.
\textsuperscript{199} See, e.g., Fletcher, supra note 127, at 445-48.
\textsuperscript{201} SEC Tables Proposal, supra note 136 (quoting SEC Division of Market Regulation Director Richard Ketchum).
\textsuperscript{202} Id.
\textsuperscript{203} Id. (quoting SEC Chairman David Ruder); see also CFTC Staff to Recommend, supra note 194, at 859 (Non-mandatory arbitration agreements in commodities trading means "arbitration in the futures industry has great advantages over securities arbitration," according to CFTC member.).
maintain case accounts are not required to sign agreements, and
margin account customers may avoid agreements by borrowing
from banks rather than the brokerage houses. Furthermore, one
commentator questions whether brokerage houses as profit-or-
iented businesses would turn away customers unwilling to sign
agreements.

A possible alternative approach is a two-tiered commission
structure allowing customers access to even margin and option
accounts without arbitration agreements. This differential in
price for services would reflect the additional cost associated with
litigation as a dispute resolution method. However, questions re-
garding limits on non-agreement surcharges, and the viability of
such a two-tiered structure in a highly competitive market, remain
unanswered.

Further improvements to arbitration procedures are needed.
But the danger exists that the present advantages of arbitral fo-
rums might be lost in alterations that imitate litigation. A merger
of arbitration and litigation, much like that of law and equity,
has also been predicted as a result of changes to protect inves-
tors.

Changes in arbitration procedures and the selection of arbitra-
tors may not be sufficient to eliminate the perception of unfair-
ness. On the other hand, arbitration procedures conducted by
an independent agency, unaffiliated with any SRO or the securities
industry, but remaining under the oversight authority of the SEC,
are likely to insure investor confidence in unbiased arbitration.

Dispute resolution must be fair and unbiased, in appearance
and in practice. Perhaps only the passage of time and increasing
numbers of apparently fair and satisfactory customer recoveries
will legitimize securities arbitration in the public eye. If linked
with progressive reforms to arbitration and forums independent
of the securities industry, customer recoveries should result in
strong investor confidence. With public faith in arbitral proceed-
ings, the primary function of broker-customer arbitration can be

203 Massachusetts Proposal, supra note 4, at 1219 (citing Paul DuBow, Senior vice
president and deputy general counsel for Dean Witter Reynolds, Inc.).
204 See Hood, supra note 137, at 578.
205 Katsoris, supra note 82, at 375.
206 Id.
207 Fletcher, supra note 127, at 463-67.
208 Id.
209 Katsoris, supra note 82, at 383-86.
accomplished—the protection of investors through fair and expeditious dispute resolution.

CONCLUSION

In the *Rodriguez de Quijas* decision, the Court took a major step in promoting arbitration as a system of dispute resolution beneficial to all parties involved. It determined that improvements to arbitration indicate that disputes under either the Securities Act or the Exchange Act may be resolved through arbitration without infringement of investor rights. The Court endorsed the SEC interpretation that past controversies regarding the purposes of the Securities Act and the Exchange Act are well resolved by a focus not on the rights granted by the acts themselves, but on the contractual nature of predispute arbitration agreements. The need for harmonious interpretation of the two acts is consistent with current Supreme Court thought regarding the requirements for overruling its own precedent. Moreover, this reluctance to reverse earlier Court pronouncements indicates that the *Rodriguez de Quijas* decision will have lasting impact.

This Comment demonstrates that arbitration of securities disputes is fair and non-discriminatory. The public image of bias is probably the most serious problem in securities arbitration today. This perception can be corrected by reforms such as increased discovery, redefinition of "industry" arbitrators, and award summaries. The permanent solution, however, apparently lies not in changes to resemble litigation, but in the establishment of arbitration proceedings independent of the SROs and the securities industry. Dispute resolution untainted by suspicion can preserve securities arbitration as it should be, a swift and economical tool to settle broker-client controversies.

*Leslie William Moore*

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212 See supra notes 52-66 and accompanying text.
213 See supra notes 125-28 and accompanying text.
214 See supra notes 149-55 and accompanying text.
215 See supra notes 174-80 and accompanying text.
216 See supra notes 158-66 and accompanying text.
217 See supra notes 182-211 and accompanying text.