Securities Arbitration: Is Required for Arbitration Fair Investors?

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J. Kirkland Grant*

[It is not merely of some importance, but of fundamental importance, that justice should both be done and be manifestly seen to be done.1

TABLE OF CONTENTS

I. Introduction ......................................................... 391
II. The Problem of Arbitration and the Securities Laws .......... 394
   A. The Numbers .................................................. 396
   B. The Economics ............................................... 399
      1. Cost Savings as a Justification for Arbitration .. 400
      2. Two-tier Pricing ......................................... 402
      3. Advantages of Standardized Contracts ............... 403
   C. Brokers Prefer Arbitration .................................. 406
   D. Should Investors Prefer Arbitration? .................... 407
III. Pre-McMahon Securities Arbitration ........................... 407
   A. Common Law ............................................... 407
      1. Common Law Disfavor of Arbitration: Venue
         Considerations ......................................... 412
   B. English Arbitration as Precedent ....................... 415
   C. Federal Arbitration Act of 1925 ......................... 416
   D. Interpretations of Arbitration Act In Securities
      Cases Prior to McMahon ................................ 420
   E. Wilko v. Swan ............................................ 425
   F. Wilko’s Progeny .......................................... 428
IV. McMahon ............................................................ 432
   A. The McMahon Facts ........................................ 433
   B. McMahon’s Holding ....................................... 435

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C. Analysis of McMahon: Future Issues .......... 440
V. Rodriguez de Quijas ......................... 441
   A. The Rodriguez de Quijas Facts .......... 442
   B. The Rodriguez de Quijas Holding ...... 443
   C. Rodriguez de Quijas Analysis ......... 445
VI. What's Next? .................................. 446
   A. State Law .................................. 447
   B. Arbitration in Non-Securities Areas ... 448
VII. Arbitration Generally ........................ 448
   A. Common Law Arbitration ................. 448
       2. Public Policy Defense ............... 457
       3. Unconscionability Defense .......... 457
       4. Fraud in the Inducement ............. 459
       5. Waiver of Right to Arbitrate ....... 460
           a. Waiver in Securities Cases ....... 462
       6. Other Contract Defenses .............. 466
       7. Result .................................. 467
   B. Statutory Arbitration ..................... 467
       1. Uniform Arbitration Act ............... 469
       2. Recent State Arbitration Enactments 470
       3. United States Arbitration Act ...... 470
       4. Result Favors Arbitration .......... 471
   C. Appeal of Court Orders on Arbitrability 471
   D. Finality of Arbitration ................... 472
       1. Order of Dispute Resolution ...... 476
       2. Collateral Estoppel ................. 476
       3. Sanctions .............................. 479
VIII. Securities Arbitration ...................... 480
   A. SRO Forums ................................. 480
       1. The AMEX Window ...................... 483
   B. American Arbitration Association ...... 485
   C. Other Arbitration Forums ............... 486
       1. Private Alternative Dispute Resolution 486
   D. Arbitration Procedures ................... 487
       1. Bringing the Claim; Location of Hearing 489
       2. Securities Industry Arbitration Panels 490
           a. Bias—A Perception Problem or Grounds to Challenge? 490
           b. Disclosure of Bias ................ 494
           c. Classification of Arbitrators .... 494
       3. Training Arbitrators ................. 495
       4. Evaluation of Arbitrators .......... 495
       5. The Present Situation ............... 496
       6. SEC Approval of SRO Rule Changes ... 497
I. Introduction

Three recent events will have a far reaching impact on the resolution of disputes between brokerage firms and their customers. Two of these events occurred in 1987. The first, a United States Supreme Court ruling, *Shearson/American Express, Inc. v. McMahon*, held that securities industry customers who have signed standard contracts opening brokerage accounts, most of which contain standard clauses selecting predispute arbitration forums for resolution of disputes, select predispute arbitration forums for resolution of disputes.


3. Most such clauses are similar to the Shearson Lehman Hutton, Inc. Client Agreement and contain language such as:

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ARBITRATION AND GOVERNING LAW. This agreement shall be governed by the laws of the State of New York without giving effect to the choice of law or conflict of laws provisions thereof. Any controversy arising out of or relating to any of my accounts, to transactions with you, your officers, directors, agents and/or employees for me, or to this agreement, or the breach thereof, or relating to transactions or accounts maintained
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were relegated to the alternative dispute resolution process in the event of a dispute and could not apply to the courts for judicial relief. *McMahon* concerned claims under several provisions of the federal securities laws[^4] and the Racketeer Influenced and Corrupt Organizations Act (RICO),[^5] all of which were found to be arbitrable in a securities indus-

by me with any of your predecessor firms by merger, acquisition or other business combination from the inception of such accounts, shall be settled by arbitration, in accordance with the rules then in effect of the NASD (National Association of Securities Dealers), or the Boards of Directors of the NYSE [New York Stock Exchange] or the American Stock Exchange, Inc., as I may elect. If I do not make such election by registered mail addressed to you at your main office within 5 days after demand by you that I make such an election, then you will have the right to elect the arbitration tribunal of your choice. Judgment upon any award rendered by the arbitrators may be entered in any court having jurisdiction thereof.

Shearson Lehman Hutton, Inc. Client Agreement, Form 8025 (2/88). See also infra note 229 (the *McMahon* clause).

The language used by other firms is slightly different. It may be in the regular text of the customer agreement or may be in bold type. For example, Merrill Lynch, Pierce, Fenner & Smith, Inc. highlights the clause in bold red print. See Robbins, *A Practitioner's Guide to Securities Arbitration*, in 601 SECURITIES ARBITRATION 1988, 13, 32-34 (D. Robbins ed. 1988).

Prior to the *McMahon* decision it was common for firms to include a sentence to the following effect in the arbitration clause of the customer's contract: "It is understood that such arbitration does not operate as a waiver of my right to bring a judicial action for claims under the securities laws." This provision was required under a 1983 Securities and Exchange Commission adoption of Rule 15c2-2. See infra note 167 and accompanying text.

Arbitration may also be required under documents other than the customer agreement. For example, customer confirmations of trades, monthly statements and other communications may indicate that arbitration is the means to resolve disputes with the brokerage firm. See Middlebrooks v. Merrill Lynch, Pierce, Fenner & Smith, Inc., Fed. Sec. L. Rep. (CCH) ¶ 94,399 (N.D. Ala. Apr. 5, 1989) (account statements, confirmation slips and even checks received by plaintiffs over a period of years provided for arbitration of "[a]ny controversy between us arising out of the transactions in this account or in this agreement... "). *Id.*


try forum. Securities arbitration, rather than judicial action, thus became the appropriate forum for resolution of most investor-broker disputes.\(^6\)

The second event, which will have a long-reaching effect on the arbitration process in the securities industry, occurred less than five months later—the October 19, 1987, “Black Monday” decline in the stock market. The stock market declined over 500 points on the Dow-Jones averages,\(^7\) over 22% of the Dow value, on one day’s extraordinary trading. “[T]he value of all outstanding U.S. stocks decreased by almost $1.0 trillion.”\(^8\)

One of the aftershocks of Black Monday was the sell-out of margin customers, often without notice from the brokerage firms. A flood of legal claims has been filed by customers for losses associated with the stock market plunge that day.\(^9\) Included are disputes regarding improper executions, inaccurate quotes, non-execution of trades ordered, poor price executions, precipitous liquidation of margin accounts without notification and ability to cover margin calls. Under the \textit{McMahon} precedent, most of these claims will be resolved by industry arbitration pursuant to the customer brokerage firm predispute arbitration agreement.\(^10\)

The third event, which was the final test of securities arbitration, came in May 1989 when the United States Supreme Court decided \textit{Rodriguez de Quijias v. Shearson/American Express, Inc.}\(^11\) In \textit{Rodriguez de Quijias} the Supreme Court ended speculation resulting from \textit{McMahon}, because the Court had not overruled a twenty-six year old precedent regarding customer-broker arbitration and claims concerning violation of certain federal securities laws.

This article will examine the law prior to \textit{McMahon} and \textit{Rodriguez de Quijias}. It will discuss the common law view of arbitration and its change

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6. This is true even for actions involving federal securities laws. \textit{See infra} notes 128-50 and accompanying text.


10. \textit{See infra} notes 234-46 and accompanying text.

by the Federal Arbitration Act of 1925. The interaction of the federal securities laws and arbitration will be examined in light of the case law, including the 1953 landmark case of Wilko v. Swan, which held claims under section 12(2) of the Securities Act of 1933 to be nonarbitrable. The article will then consider the development through Wilko's progeny up to its clear reversal in McMahon and Rodriguez de Quijas, along with the impact these decisions had on investors and the securities industry.

This article will also discuss the arbitration process and forums within the industry, and the recent American Arbitration Association securities industry arbitration, including the typical procedure to begin and present a securities case in arbitration. Some of the proposals for reform in the area of securities arbitration of customers' disputes, especially the May 1989 Securities and Exchange Commission (SEC) approval of new arbitration rules, the Spring 1989 Massachusetts regulations, and congressional and other proposals will then be examined. Finally, this article will discuss whether such proposals will adequately refine the process of arbitration to protect the investor in today's securities markets.

II. THE PROBLEM OF ARBITRATION AND THE SECURITIES LAWS

Processing cases in an alternative forum to the courts has become popular in recent years. Chief Justice Burger made this one of the hallmarks of his tenure, supporting alternative dispute resolution as a way of easing the perceived burden on the court systems of the country. But the alternatives may also yield qualitatively better results for disputes where it is wise to avoid the adversary nature of litigation or where more expertise is necessary than judges possess. Speed and cost "efficiencies" are also given as other reasons for using such alternative methods.

Arbitration provisions to govern dispute resolution within the se-

15. See infra notes 172-89 and accompanying text.
16. See infra notes 793-829 and accompanying text. These regulations, promulgated by the Office of Secretary of State, Securities Division, amended 950 CMR 12.04 by adding a new section 12.204(a)(2)(G) and were to be effective January 1, 1989. The court found these regulations to be invalid under the Arbitration Act before the effective date. Securities Indus. Ass'n v. Connolly, 703 F. Supp. 146, 155-56 (D. Mass. 1988).
securities industry have existed for over a century. While there is little question that industry members can opt for arbitration rather than litigation, the issue of whether a claim is arbitrable comes to the forefront when arbitration is sought against a non-industry person, usually an investor. One of the basic issues in securities arbitration is the question of arbitrability of the rights of investors established by the 1933 Act and the Exchange Act in the aftermath of the market crash of 1929 and depression. Both Acts recognized the injury to the economic interests of the nation caused by the imbalance between investors and those in the industry. Both promote the policy of protecting the investor by requiring disclosure and fair and equitable dealings in the marketplace.

A recurring theme in this article is the question of investor protection in light of arbitration clauses required as a condition of doing business with securities brokers. The securities laws were enacted in part to protect investors from sophisticated and perhaps unethical brokerage firms. "There is a strong argument, however, that one of the purposes behind the enactment of the securities acts was to prevent securities dealers from requiring investors to enter into agreements which purport to waive rights granted the investor under the securities laws."24

There is quite a difference between arbitration and litigation. As the Supreme Court stated in Bernhardt v. Polygraphic Co. of America:25

[Arbitration, whatever its merits or shortcomings, substantially affects the cause of action created. . . . The nature of the tribunal where suits

19. See infra notes 516-47 and accompanying text (discussion of the SRO arbitration practices). The early arbitration was between members of the exchanges, not in relation to investors dealing with such persons.

20. See infra notes 87-101 and accompanying text.

21. Several cases raise the question of institutional bias of the arbitration panels. Today it seems well-established by McMahon and the cases concerning arbitration prior to it, that there is no substantial evidence to support institutional bias claims. See infra notes 584-605 and accompanying text. See also Heily v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 202 Cal. App. 3d 255, 248 Cal. Rptr. 673, (1988), cert. denied, 109 S. Ct. 1123 (1989).


23. See Malcolm & Segall, The Arbitrability of Claims Arising Under Section 10(b) of the Securities Exchange Act: Should Wilko Be Extended?, 50 ALB. L. REV. 725, 727 n.14 (1986) (citing Greater Iowa Corp. v. McLendon, 378 F.2d 783, 795 (8th Cir. 1967)) (stating that it is "well recognized that the securities and exchange legislation has broad remedial purposes for protection of the investing public and should be liberally construed"); see also SEC v. National Bankers Life Ins. Co., 334 F. Supp. 444, 455 (N.D. Tex. 1971) (the purpose of the 1933 Act was to permit the public to rely on fair dealing in the securities markets), aff'd, 477 F.2d 920 (5th Cir. 1973).


are tried is an important part of the parcel of rights behind a cause of action. The change from a court of law to an arbitration panel may make a radical difference in ultimate result.26

It is precisely the question of the investor’s parcel of rights versus the industry’s interest in arbitration which this article examines.

A. The Numbers

In a 1987 study by the Division of Market Regulation of the Securities and Exchange Commission (SEC), of the sixty-five firms surveyed, which account for over 90% of brokerage customer accounts, arbitration clauses were required in 89% of firm margin account agreements, in 83% of option agreements, but in only 40% of cash accounts.27 A

26. Id. at 203.

<table>
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<tr>
<th>TYPE OF ACCOUNT</th>
<th># OF FIRMS</th>
<th># OF FIRMS WITH SUCH ACCOUNTS</th>
<th>% OF ACCTS COVERED BY ARBITRATION CLAUSES</th>
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<tr>
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<td>48</td>
<td>96%</td>
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<tr>
<td>OPTIONS</td>
<td>54</td>
<td>45</td>
<td>95%</td>
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<td>CASH</td>
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<td>29</td>
<td>39%</td>
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<td>NYSE</td>
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<td>25</td>
<td>22 (88%)</td>
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<tr>
<td>NASD</td>
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<th>OPTIONS ACCOUNTS SUMMARY</th>
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<td>% OF ACCOUNTS COVERED CURRENTLY BY CLAUSES</td>
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<tr>
<td>NYSE</td>
<td>NYSE</td>
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<tr>
<td>25</td>
<td>21 (84%)</td>
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<td>NASD</td>
<td>24 (83%)</td>
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Id. at 172-74.
1988 SEC staff survey found that there were an estimated thirteen million cash accounts held by individual investors of which 39% included arbitration clauses. The same survey estimated 5.5 million margin and option accounts of which 99.5 to 99.6% provided for mandatory predispute arbitration.28

A growing number of disputes have been taken to arbitrators in recent years. The American Arbitration Association (AAA) reported 1,750 arbitrations in 1950 of which fewer than 500 were commercial. The great majority were labor arbitrations. "In 1985 the total number of arbitrations had increased more than 25 times to 45,000, over 8,000 of which were commercial."29 This explosion is replicated in the securities industry forums. In the year ending March 31, 1987, there were 3,050 cases dealing with securities, commodities and exchange claims filed in the federal district courts.30

Effective September 1, 1987, the American Arbitration Association adopted Securities Arbitration Rules (AAA Rules) to administer securities arbitrations.31 Previously, securities arbitrations were administered under the AAA’s Commercial Arbitration Rules. The AAA reports that

See also Blodgett, Churning Your Broker, 74 A.B.A. J. 32 (Oct. 1988) ("since Shearson, brokerage firms have been sending new agreements to investors with cash accounts asking that they, too, agree to submit any disputes to arbitration.") Chairman Ruder noted his concern with this trend.

The District Court of Massachusetts found that a significant number of commodities customers preferred not to enter into arbitration agreements when given the choice; more than 34% fewer for Shearson Lehman Hutton and 58% fewer for Paine Webber than other securities customers. Securities Indus. Ass’n v. Connolly, 703 F. Supp. 146, (D. Mass. 1988). Of course, in the commodities area, the Commodity Futures Trading Commission (CFTC) has mandated disclosure to the customer as a prerequisite election for enforcement of predispute arbitration agreements, and opening an account can not be conditioned on agreeing to a predispute arbitration clause. See infra note 525 and accompanying text.

28. Daily Report for Executives (BNA) No. 131 (July 8, 1988). The staff said that the decision not to use arbitration clauses had lessened because the brokerage firms indicated earlier that they would add such clauses in cash accounts after McMahon. Some regional firms were competing for customers on the basis that they did not require such clauses. Chairman Ruder attributed lack of use to SEC deliberations and threat of legislation. Id.


Professor Fletcher notes that AAA arbitration in commercial and labor cases more than doubled from 1975 to 1985. Fletcher, Privatizing Securities Disputes Through The Enforcement of Arbitration Agreements, 71 Minn. L. Rev. 393, 394 nn.7-9 (1987).


in 1986, under the previous commercial arbitration rules, its thirty-four offices processed 119 securities disputes involving over $15.5 million in claims. In 1987, it processed 187 disputes (53 under the new AAA Rules, the remainder under the commercial rules)\(^{32}\) involving $80,988 million and in 1988, 495 securities claims.\(^{33}\) Of the 495 claims received in 1988 under the AAA Rules, 105 cases in Miami and 73 in New York alone had combined claims totaling $266,835,861.\(^{34}\)

During approximately the same period, 2,000 cases were arbitrated by the Self-Regulatory Organizations (SROs), the industry sponsored forums.\(^{35}\) One SRO forum, the National Association of Securities Dealers (NASD), reported that its caseload increased on an average of 31% per year from 1980 to 1986 and the number of arbitration cases filed in 1987 was up 82% over 1986. In 1988, the increase was 32%, with 3,990 cases filed versus 2,886 in 1987 and 1,587 in 1986 (151% increase from 1986 to 1988).\(^{36}\) The New York Stock Exchange, Inc. (NYSE) experienced a 67% increase in filings in 1988,\(^ {37}\) totaling 1,629 cases.\(^ {38}\) Adding the non-SRO tribunals, such as the AAA, the number of arbitral disputes may have equaled those filed in federal courts. By 1988 over 10,000 claims had been submitted to SROs under the small claims procedures of the Uniform Code.\(^ {39}\)

The SEC received 10,392 complaints regarding securities matters in 1987, up 121% from 1982.\(^ {40}\) Of course, the SEC does not adjudicate disputes. It informs brokerage customers to seek remedies through

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32. See AAA Rules, supra note 31, at 96.

Where a clause provides for submission to AAA Rules, the AAA will apply those rules [the Securities Arbitration Rules] unless a party objects, in which case the date of submission becomes controlling: cases before the September 1, 1987 effective date of the securities rules will be governed by the AAA's Commercial Arbitration Rules. See Zotto, Which AAA Rules Apply in a Securities Arbitration Case?, Arbitration Times, Fall 1988, at 8, col. 2.

33. See Zotto, supra note 32, at 8.


35. Id. at 395. See also Fletcher, supra note 29, at 394. The term SRO as applied to industry organizations comes from the Exchange Act § 15 provisions discussed briefly in the text infra note 70. See also infra note 516 and accompanying text.


37. There were 1,050 cases filed in 1987 and 1,629 in 1988, which accounts for the 67% increase. See Arbitration Caseloads Expected to Rise in Wake of Market Crash, Alternative Dispute Rep. (BNA) No. 1, at 278-70 (Nov. 12, 1987); Morris, supra note 8, at 228.

38. Robbins, supra note 34, at 34.


40. Ingersoll, Sleepy Watchdogs: Regulation of Brokers by Securities Industry Seems to be
other channels. The National Association of Securities Act Administrators (NASAA) estimates over 4,100 claims were filed in 1987, up from 800 in 1980.41

There is reason to suspect that due to the nature of customer agreements, together with the McMahon and Rodriguez de Quijas decisions, the crash on Black Monday, and the subsequent market volatility evidenced by the Friday, October 13, 1989 decline of 190 points in the Dow Industrial Average, the number of arbitrated claims will exceed those litigated.42

B. The Economics

Delay in the courts and the expense of litigation justify examining all alternatives for speedy and cost-effective dispute resolution, and not only in the securities area. Judge Irving J. Kaufman of the Court of Appeals for the Second Circuit has noted that the “twin demons of expense and delay” plague parties in litigation in the federal courts.43 He felt that liberal discovery rules are used by the parties to make onerous demands on their adversaries and release only the most limited information in response to legitimate requests. Simultaneously, these rules stifle discovery by “swamping opponents with papers when only a few documents are necessary.”44 His sentiment regarding the abuse of discovery has been reflected in the decisions as well.45

One of the major advantages to securities industry sponsored arbitration is time: arbitration takes less time to proceed to a final award than a judicial action. In 1988, NYSE arbitrations lasted, on the average, 8.2 months from receiving the claim to releasing the award; 12.1 months at the NASD; and at the AAA, a median of 168 days.46

Faltering, Wall St. J., July 21, 1987, at 1, col. 6. The biggest surge involve unauthorized trading, high-pressure sales tactics and churning. Id.


44. Krebsbach & Friedman, supra note 30, at 586. Krebsbach concludes: Unfortunately, the discovery process is frequently as extensive for small cases as it is for large ones, making the former even less cost effective for investors. Since oftentimes neither the plaintiff nor the defendant wins in the current court system, regardless of the size of the case, there are strong public policy reasons for arbitrating these disputes.

Id. at 588.

45. See, e.g., Kaufman, supra note 43.

1. Cost Savings as a Justification for Arbitration

The claim that arbitration costs less than litigation is often made to support arbitration. Significant differences are shown to exist which should lead the brokerage firms to induce customers to enter into dispute resolution agreements. In fact, however, the inducement for customers may be a benefit to the general customers of brokerage firms regardless of whether they agree to predispute arbitration. Usually the major inducements to use a particular firm center on its commission structure and other services, such as investment advice, custodial services for securities, and the like. Most people do not enter customer-broker contracts ever expecting to have a dispute which can not be resolved between them without the involvement of any outside adjudicator.47

Several reports deal with the savings in utilizing arbitration rather than judicial dispute resolution.48 A report of Deloitte, Haskins & Sells for the New York Stock Exchange indicated that for the period October 1, 1987 to June 30, 1988 the average legal costs for arbitration were $12,000 less than those for litigation.49 To require litigation in all cases would, therefore, add substantially to the legal fees of brokerage firms.50 A major portion of this saving comes from elimination of pretrial discovery. Often no depositions or interrogatories are permitted, and, if allowed, they are limited in scope by agreement of the parties. Furthermore, motion practice is generally not available. In arbitration there is more freedom to hear evidence that can be tied to the dispute, without regard to the formal rules of evidence.

Of course, these advantages relate to the normally contemplated savings in time as compared to litigation, especially with the limited right of appeal from an arbitrator's award.51 The other attributes of

47. See Rakoff, Contracts of Adhesion: An Essay in Reconstruction, 96 Harv. L. Rev. 1174, 1220-30 (1983), which states:

[T]he parties will rely to a large extent on each other's good faith in the event of a dispute. But the assumption is that the law will stand as a backup should good faith fail, and that the existence of this sanction will encourage good faith in the first place.

Id. at 1228 n.196.

48. See, e.g., Moulin, supra note 41, at 396, 415, 417.

49. Morris, supra note 8, at 250.

50. Securities Indus. Ass'n v. Connolly, 703 F. Supp. 146 (D. Mass. 1988). The Connolly court noted that the Massachusetts regulations forbidding arbitration without voluntary consent could add between one-quarter to one-half million dollars annually to the legal fees of the Massachusetts brokerage firms which were joined with the SIA as plaintiffs in that case. "Customer legal expenses are likely to mirror broker legal expenses; the finding of the . . . study that broker-dealer legal expenses are significantly less in arbitration than in court litigation may accordingly also be interpreted as predicting relative economic benefit favoring arbitration for the customer." Id. at 159.

51. See infra note 470-86 and accompanying text.
the arbitral process—minimization of time spent by the parties in the hearing and discovery process, the lack of publicity and public record, and the less adversarial tone of arbitration—also result in direct and indirect potential legal and business savings.\textsuperscript{52}

There is more support for arbitration of claims in margin, commodities, and options accounts than when the investor uses the broker only for the purchase and sale of securities. When the investor margins securities, he or she is borrowing funds from the broker to finance securities transactions. Much the same situation exists with the typical commodities and options customer—he or she is also working with the credit of the brokerage firm in buying and selling the commodity or option contracts. It may be that these increased risks created through the use of the brokerage firm’s credit led to the conclusion that the broker’s ability to recover should be enhanced by the speedy and efficient arbitration process. This extension of credit can be analogized to bank lending arrangements, many of which also contain arbitration provisions.\textsuperscript{53} But this argument militates against imposing such arbitration on the cash account customer, who simply buys and sells securities and pays or delivers without using any service other than the pure agency of the stockbrokerage firm. There is little risk put on the broker in these cash accounts. Hence, the question of whether mandatory arbitration is appropriate in cash accounts is a major issue in the debate on enforceability of these clauses.\textsuperscript{54}

The Deloitte, Haskins & Sells report also indicated that customers receive a higher percentage of their original claims in arbitration (19.57\% of claims recovered in arbitration versus 2.60\% in litigation).\textsuperscript{55} After reviewing these findings, the court in \textit{Securities Industry Association v. Connolly}\textsuperscript{56} concluded:

In short, on the evidence before me it appears that court litigation affords customers the opportunity to pay more in legal costs to get less in recovery. Moreover, this opportunity will apparently be preserved only

\textsuperscript{52} \textit{Id.} The new SRO arbitration rules will affect these considerations, especially regarding public disclosure awards. \textit{See infra} notes 761-75 and accompanying text; Coulson, \textit{supra} note 34, at 788-93.


\textsuperscript{54} \textit{See infra} note 743 and accompanying text.

\textsuperscript{55} Securities Indus. Ass'n v. Connolly, 703 F. Supp. 146, 159 (D. Mass. 1988). AAA statistics from 1986 show that of forty AAA cases against securities firms, 68\% (27) resulted in awards for customers, averaging in excess of $26,000. Four awards of punitive damages ranging from $50,000 to $150,000 were also reported. \textit{Id.} \textit{See also} Bedell, Harrison & Harvey, \textit{The McMahon Mandate: Compulsory Arbitration of Securities and RICO Claims}, 19 Loy. U. Chi. L. J. 1, 9 (1987) (1985 NASD statistics showed 55\% of public cases arbitrated to the award stage were decided in favor of the customer).

\textsuperscript{56} \textit{Connolly}, 703 F. Supp. at 159.
after paying for brokerage services at the higher level of the 'two-tiered commission scheme' [if the two-tiered commission scheme to reflect these higher industry costs is adopted as is a likely response to regulations mandating customer waiver of litigation].

A 1989 study by the SEC Division of Market Regulation examined NYSE data on claim recoveries from litigation, versus arbitration, in a very limited sample of cases. It found no significant difference in the percentage of claims recovered in one forum over the other. This study concluded that litigated cases take longer and cost more than those arbitrated, but noted that the types of claims litigated may be more complex than those arbitrated.

Another reason for the lower cost of SRO arbitration is that the forum is subsidized by the SRO members. For example, the budget of the NYSE Arbitration division in 1988 was $2 million and the NASD arbitration program expense was $7 million for fiscal 1987-1988.

2. Two-Tier Pricing

The economic argument supporting arbitration of disputes in the securities area justifies charging different prices to the customer who agrees than one who does not agree to arbitration. However, this is not the case. Instead, institutional investors, who have the greater bargaining power on negotiated commissions, are those with whom the brokerage firm will continue to deal, despite their refusal to sign a predispute arbitration agreement. The small investor, on the other hand, is the one stuck with firm established commissions, which are non-negotiable due to the minimal volume and revenues his or her trading brings to the firm. This is true despite SEC regulations prohibiting fixed commissions within the industry. Today there are negotiated commissions and discount brokers, but the small customer is certainly not going to be able to negotiate the commissions charged on a trade of a few hundred shares of the typical stock, a small number of bonds, or in limited options or commodity trading. Consequently, in today's securities markets the specter of a two-tier commission system depending on

57. Id. at 160.
59. Masucci & Morris, supra note 58, at 320. See infra notes 628-37 and accompanying text for discussion of fees of the SROs versus AAA.
whether the customer has agreed to predispute arbitration is purely speculative.\footnote{Former SEC Chairman David Ruder has said that it would be difficult for a securities firm to market such a concept. Daily Report for Executives, (BNA) No. 134 (July 13, 1988). But see supra note 27. Professor Ruder resigned and was replaced as SEC Chairman in late 1989 by Richard C. Breedon.}

Arbitration may well be the only available means of dispute resolution for the small investor—even one with a cash account. In fact, these investors are already faced with sometimes paying greater charges for mailing and other expenses incurred by the brokerage firms, whether in the form of higher commissions or service charges for preparing statements, custodial fees, or account maintenance charges. Even with these fees, the small investor is probably uneconomic to the brokerage firm.\footnote{See Herzl & Harris, An ambiguous victory for the small brokerage client, Financial Times, June 30, 1988, § 1, at 9, col. 1.}

One must bear in mind, however, that small investors can utilize brokers who do not require predispute arbitration clauses, but they probably invest (or have invested by others) much more of their capital in mutual funds or pensions. Typically, mutual fund accounts are not subject to arbitration clauses nor are institutions managing pension investments.\footnote{See Fitzpatrick, supra note 53, at 254. See infra notes 342-57 and accompanying text. But see Bird v. Shearson Lehman/American Express Inc., 871 F.2d 292 (2d Cir. 1989), vacated, 110 S.Ct. 225 (1989).}

3. Advantages of Standardized Contracts

The brokerage firms have created standard form contracts for several purposes.\footnote{See supra note 47 and accompanying text. See also infra note 342 and accompanying text.} The standard contract will reduce administrative and transaction costs. This may result in lower prices for the consumer.\footnote{One industry spokesman indicates that the lower cost of dispute resolution through arbitration may even enable “American financial service companies to control costs and therefore compete more effectively with foreign rivals” since arbitration costs are significantly lower than the cost of litigating in the American Court system. See Hammerman & Cummings, Defending a Brokerage Firm, in 601 SECURITIES ARBITRATION 1988 619, 625-31 (D. Robbins 1988) (Statement of Stephen L. Hammerman Before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce).} Standardization also promotes efficiency within the large organization and promotes efficient use of managerial and legal resources, as well as acting as a check on wardward behavior. The use of standard forms for drafting party protective documents is suspect, but is clearly another reason they are used.\footnote{This is combined with the small investor’s feeling of helplessness, and an obligation to accept the take-it-or-leave-it terms imposed on him by the broker if he}

In oligopolistic industries, where there are several large organiza-
tions selling goods or providing services, freedom of contract notions have pretty well disappeared. Monopolies clearly would like complete control over all aspects of the market and can require it. With oligopolistic markets, much the same result will occur for those matters which the firms can agree on, or which are not important to the consumer. The contract of adhesion argument thus becomes the law’s way of policing industry behavior. This is especially necessary when regulation of the industry no longer exists. While the securities industry today is still highly regulated, much of the regulation is self-imposed and, as one might assume, form-pad agreements have resulted. These form-pad agreements are similar in most respects, and certainly similar in broker-protective terms. One industry spokesman stated:

[T]he brokerage industry is not a public utility. Basically, society decides that in a case where an entity enjoys a “natural monopoly” in the provision of some good or service judged to be essential (e.g., electricity, water, some forms of [sic] transportation, etc.) that entity should be treated as a public utility. Of course, none of these criteria are present in the case of brokerage services. But the [SEC] Division [of Market Regulation]’s radical proposal [to impose a standard form of contract clause regarding arbitration] would in large measure institute just such a regulatory approach. The Division has apparently decided that public customers must be offered access to the capital markets on terms that the Division regards as reasonable, and as a result, the Division would undertake to have the SEC decide what substantive provisions may be contained in contracts with the public.

Precisely because the provision of brokerage services is not an instance of “natural monopoly,” there is a great deal of consumer choice available. For instance, customers have a choice not only of trading or not trading in the securities market, they also have the choice of trading either on a cash or margin basis. They may also choose to trade options, again either on a cash or margin basis and they can also choose the broker with whom they wish to do business. But simply because a person chooses a particular broker does not mean that the broker in turn wishes to do business with that person. When opening an account a broker may request that the customer sign an agreement which contains a clause to arbitrate disputes. The customer is free at this point to sign or not to sign. The customer is also free to attempt to negotiate and amend the contract if the customer is not pleased with

wants the product or service. This justifies, to him at least, the requirement of disclosure of terms of an adhesive nature. See Rakoff, supra note 47, at 1229.

68. “The ideal [contracting party] who would read, understand, and compare several forms is unheard of in the legal literature and, I warrant, in life as well.” Id. at 1226.

69. See Kessler, Constructs of Adhesion — Some Thoughts About Freedom of Contract, 43 Colum L. Rev. 629 (1943). See also infra note 322 and accompanying text.

70. See infra notes 516-37 and accompanying text for a discussion of the industry regulation by the Securities and Exchange Commission (SEC) and Self Regulatory Organizations (SROs).
the terms of the contract. The broker is also free in turn to either accept the amendment suggested by the customer or refuse to do business with the customer on the terms suggested by the customer. This is how the free market works.

It has been suggested that the customer has been deprived of his freedom of choice, if a broker requests a customer to sign an agreement containing an arbitration clause and the customer decides not to do so. This is clearly not so. The customer has exercised his choice by not signing and now is free to approach any and all brokers to determine if he can convince one of them to do business on his terms. In the unlikely situation in which such a customer cannot find any broker in the whole country to do business with him on this basis, he can turn to mutual funds. Even if he cannot find anyone in the whole world to do business with him, the customer has exercised his freedom of choices. Choice is a “two way street.” Some appear to define choice to mean the ability to mandate that a broker do business on a customer’s terms. This is not a choice.

Again, the securities industry is not a public utility. There is no obligation on broker-dealers to provide a service to everyone who walks in the door. Our industry is not a monopoly; it is free access industry. There is no societal reason to force broker-dealers to do business with people under conditions that the broker-dealer in its business judgment does not deem appropriate. Absent an agreement that contains a clause which would be void against public policy, in a free market economy, the government ought to enforce agreements between citizens. The government should not seek to intervene in the formation of such agreements.\textsuperscript{71}

Nevertheless, the influence of state regulation on arbitration has resulted in one court finding that the probable “influence the . . . regulations will have on commission rate structure suggests insinuation by local Blue Sky\textsuperscript{72} authorities into brokerage commission rate making, an area in which the SEC exercises full authority.”\textsuperscript{73} This supported a finding that a two-tiered rate structure might not be of benefit to consumers, as commission rates might be raised for all to absorb the increased costs resulting from non-mandatory arbitration which will lead to litigation.\textsuperscript{74}

Several commentators have, however, questioned the economic sav-

\textsuperscript{71} Fitzpatrick, supra note 53, at 299-301.


\textsuperscript{74} Id.
ings resulting from mandatory arbitration.\textsuperscript{75} One of the basic conclusions is that there will be less effort to settle the dispute when the costs of submission to arbitration, rather than the larger costs of discovery and the litigation process, are involved. It may be for this reason that the percentage of claim recoveries is skewed in favor of arbitration: there are few reports of settled cases included in the surveys.\textsuperscript{76} With the publication of awards under the SRO rules adopted in May 1989,\textsuperscript{77} analysis of the economics of securities will be made easier.

C. Brokers Prefer Arbitration

Brokers prefer arbitration. It is clearly expedient\textsuperscript{78} and less expensive than trial by jury and other litigation.\textsuperscript{79} But arbitration clauses have typically been in fine print, and in most cases are explained inadequately, if at all, by the account executive or broker to the customer while filling out all the forms necessary to open his or her brokerage account.\textsuperscript{80} Much of the transaction is considered "boilerplate"—by both the customer and broker.

Another reason brokers prefer arbitration is that the arbitrators, particularly in SRO arbitrations, are familiar with the industry. As a result, the brokerage firm's counsel in an arbitration hearing does not have to educate the arbitrators as to particular customs and practices of the industry. In litigation, both the judge and jury will possibly need such education.

In addition, arbitration is an informal process which is less adversarial in nature than litigation and therefore tends to be more conducive to continued business relationships.\textsuperscript{81} Another major advantage is lack of publicity and absence of \textit{stare decisis}.\textsuperscript{82}

\begin{itemize}
\item[75.] See Katsoris, supra note 39, at 361, 374-75.
\item[76.] See Kronstein, \textit{Business Arbitration-Instrument of Private Government}, 54 Yale L.J. 36 (1944); Kritzer & Anderson, supra note 18, at 6.
\item[77.] See infra notes 682-87 and accompanying text.
\item[78.] In most cases, arbitration takes less than a year, whereas litigation takes two to three years to reach trial, discounting any additional time used to exhaust appeals.
\item[79.] But see infra note 629 and accompanying text. There is some support to the conception that arbitration awards are less generous than jury verdicts, but there is no way to quantify this impression. See Comment, Shearson/American Express v. McMahon: \textit{The Expanding Scope of Securities Arbitration}, 12 Nova L. Rev. 1375, 1382 (1988); Note, \textit{Mixed Arbitrable and Non-Arbitrable Claims in Securities Litigation}: Dean Witter Reynolds, Inc. v. Byrd, 34 Cath. U. L. Rev. 525, 557 (1985).
\item[80.] Some brokers will open a cash account without any agreement, but this is not the case with margin or options accounts for the reasons discussed above. See generally supra notes 53-63 and accompanying text.
\item[81.] See infra notes 136-50 and accompanying text.
\item[82.] See infra note 489 and accompanying text for a discussion of collateral estoppel. Judicial review of arbitration awards is permitted under § 10 of the Federal Arbitration Act only:
\end{itemize}
However, there does not seem to be any measurable preference for arbitration based on analysis of the results of arbitration. While there are few comparisons of litigation and arbitration recoveries, arbitration recoveries often support the customer.

D. Should Investors Prefer Arbitration?

There is no reason to suppose that the arguments regarding arbitration’s cost effectiveness and speed would not also lead a customer to want to utilize this forum of dispute resolution. In fact, under SRO rules, the customer can require arbitration of disputes even when he has not signed an arbitration agreement. Of course, if the customer already has this option, the question arises why he or she should ever sign an agreement forcing him or her to arbitrate.

III. Pre-McMahon Securities Arbitration

A. Common Law

The law regarding arbitration was well defined prior to the 1987 McMahon decision. Through legislative enactments allowing arbitration, the common law disfavor has been removed and arbitration has become more fashionable as a means of dispute resolution.

A general principle of contract law is that parties may agree to make

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


The recent SRO arbitration rule changes which require disclosure of arbitration results are not for the purpose of establishing precedent. See infra notes 682-87, 761 and accompanying text. See also Morris, supra note 8, at 231-32.

84. See supra note 55.
86. See generally infra notes 305-21 for a discussion of the law regarding arbitration. A bifurcated approach was felt desirable first to introduce the reader to
any arrangement which they desire. Absent a public policy against such arrangement, the agreement will be enforced as within the intent of the parties. Moreover, written arbitration agreements do not need to be signed to be enforceable. Consequently, predispense arbitration

the McMahon problem of securities arbitration, and then to examine the general issues of arbitration in somewhat more detail.

See also McMurray & Ingersoll, Arbitration Can Be Better Than Litigation When Investors and Brokers Don’t Agree, Wall St. J., Apr. 30, 1986 (describing the rise in the number of securities-related arbitration cases from 830 in 1980 to 2,796 in 1985); Letter from John S. R. Shad, Securities Exchange Commission to John J. Phelan, Jr., Chairman, New York Stock Exchange (June 12, 1985), reprinted in Resolving Securities Disputes, in SECURITIES ARBITRATION 1986, 187, 197 (D. Robbins ed. 1986) (“The NYSE’s arbitration program, which has been serving investors and the securities industry so well, is bogging down under the rising volume of arbitration cases. I understand you have a present backlog of 726 cases, with delays of ten months before hearings can be held.


88. See Swenson v. Management Recruiters Int’l Inc., 858 F.2d 1304 (8th Cir. 1988), rev’d, 56 U.S.L.W. 2231 (8th Cir. 1988). The court held that the Arbitration Act did not preempt civil rights legislation because of the underlying purposes which support a congressional intent to prohibit waiver of judicial forums. The court concluded that arbitration was poorly suited as a mechanism for the final resolution of Title VII rights: arbitrators lack expertise; it is an inferior fact-finding process due to the absence of discovery; and, judicial construction through concepts of public law is necessary and arbitrators are not trained to apply this necessary construction.

The effect of Swenson was that state and federal discrimination actions must be pursued independently, even though Congress intended employment discrimination cases to have access to judicial remedies rather than arbitration. Otherwise arbitration was to be favored. Id. at 1305-08. See also supra note 83. Contra Judge Learned Hand’s opinion in Hotchkiss v. National City Bank, 200 F. 287 (S.D.N.Y. 1911):

A contract has, strictly speaking, nothing to do with the personal, or individual, intent of the parties. A contract is an obligation attached by more force of law to certain acts of the parties, usually words, which ordinarily accompany and represent a known intent. If, however, it were proved by twenty bishops that either party, when he used the words, intended something else than the usual meaning which the law imposes upon them, he would still be held, unless there were some mutual mistake, or something else of the sort.

Id. at 293.


As to the unsigned forms it is well-established that a party may be bound by an agreement to arbitrate even absent a signature. Further, while the [Arbitration] Act requires a writing, it does not require that the writing be signed by the parties. Thus, the district court did not err in finding that in this long standing and on-going relationship Genesco agreed to arbitrate disputes arising under the unsigned sales confirmation forms as well.

Genesco, 815 F.2d at 846 (citations omitted).

Arbitration clauses contained in confirmation slips sent to the customer were found enforceable. Lyman v. Drexel Burnham Lambert, Inc., Fed. Sec. L. Rep.
clauses selecting a forum for dispute resolution could be supported by the courts under concepts of freedom of contract.\textsuperscript{90} The agreement to arbitrate is perceived primarily as a forum-selection clause\textsuperscript{91} but also governs procedures to be applied.\textsuperscript{92} As long as there is no fraud involved in the parties' determination of the arbitration forum and procedures, their intention will be recognized and arbitration enforced, even if in some cases there may be a loss of the proper judicial forum carrying with it the loss of substantial rights.\textsuperscript{93}

Basically, arbitration is part of the agreement between the parties


\textsuperscript{91} Id. at 519. Scherk dealt with arbitration in the acquisition by an American company, Alberto-Culver Co., of three enterprises owned by a German citizen, together with their trademark rights. The contract contained warranties that the trademarks were unencumbered, and provided for arbitration of a controversy or claim before the International Chamber of Commerce in Paris. The purchaser alleged violation of United States securities laws and argued that Wilko should prevent such arbitration. See infra notes 174-79 and accompanying text. The Supreme Court held the arbitration clause enforceable despite Wilko and the U.S. securities law claims because of the international nature of the contract, because the parties could specify from a wide choice of law and forums which could be applicable, and to do otherwise

[w]ould not only allow the respondent to repudiate its solemn promise but would, as well, reflect a "parochial concept that all disputes must be resolved under our laws and in our courts. . . . We cannot have trade and commerce in world markets and international waters exclusively on our terms, governed by our laws, and resolved in our courts."

Scherk, 417 U.S. at 519 (quoting Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 9 (1972)).


\textsuperscript{92} Scherk, 417 U.S. at 519.

In a bankruptcy case the trustee was bound by the customer's agreement to arbitrate securities fraud claims against the broker in the same way as other cases binding a trustee to pre-petition non-executory contract clauses. The case was decided with a view of the strong federal policy of the Arbitration Act, which puts arbitration agreements on the same footing as other contracts. See Hays and Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 885 F.2d 1149 (3d Cir. 1989).

\textsuperscript{93} Scherk, 417 U.S. at 532 (Douglas, J., dissenting). Douglas, with White and Marshall concurring, noted that the international forum did not carry with it protections such as development of a record; judicial review for arbitrariness or capriciousness; federal rules for pretrial discovery; and no wide choice of venue. Id. The majority observed that the contracting parties were sophisticated businessmen "surrounded and protected by lawyers and experts." Id. at 526. Douglas discussed the rights of parties under the Federal securities laws, concluding: "The Act does not speak in terms of 'sophisticated' as opposed to 'unsophisticated' people dealing
and the question is one of contract. The arbitration clauses in contracts usually fall into three categories: broad, narrow, and middle ground. For example, a broad clause providing for arbitration of any dispute "arising out of or relating to this contract" is deemed to show the parties' intent to submit almost any dispute to arbitration. A more narrow clause agreeing to submit any dispute relating to the calculation of damages would indicate an intent to reserve disputes in all areas, other than damage calculations, to the court rather than the arbitrator. The middle ground clause is one that is considered ambiguous concerning the parties' desire to submit to arbitration the type of dispute which has arisen. As with other contracts, the court must then consider the tone of the clause within the contract as a whole in determining whether the dispute requires arbitration. Once again, there is no excuse for drafting a clause which is not clear, unless the intent is to make judicial review available. But this will defeat the major advantages of

in securities. The rules when the giants play are the same as when the pygmies enter the market."  

94. See Note, Arbitrability of Disputes Under the Federal Arbitration Act, 71 Iowa L. Rev. 1137, 1153 (1986). This Note points out the conflicting interpretations within the courts regarding the scope of arbitration depending on the use of different language in the arbitration clauses. One of the more interesting questions is whether the parties actually intended the issue of arbitrability itself to be submitted for resolution by arbitration. The broadest clauses, such as those suggested by the AAA ("any dispute arising out of or related to this contract") are normally, but not always, interpreted to permit the arbitrator to decide the issue of arbitration also. The Note suggests that in order to avoid an issue-oriented focus, with the courts determining on an issue-by-issue basis whether submission to arbitration was intended, a better approach would be for general guidelines to be established as a clear standard for determining arbitrability. But the basic question would still be the intent of the parties. See id. at 1160. An intent to avoid the judicial process can easily be stated: the contract should simply and clearly state that arbitration applies to all disputes arising under the contract, including the question of whether arbitration is available. The question of who decides if an issue is subject to arbitration has been discussed. See infra notes 141-42, 385 and accompanying text. The issue of who decides if arbitration is permissible at all is discussed infra note 318 and accompanying text.

In an interesting case, Weinstein v. American Biomaterials Corp., Fed. Sec. L. Rep. (CCH) ¶ 94,171 (S.D.N.Y. 1989), an investor was not compelled to arbitrate a dispute with a brokerage firm because the arbitration clause applied only to controversy arising out of or relating to the investor's accounts with the broker and the dispute (without more facts) did not arise out of or relate to those accounts. See also Dale v. Prudential Bache Sec., Inc., 719 F. Supp. 1164 (E.D. N.Y. 1989).

95. See Prudential Lines, Inc. v. Exxon Corp., 704 F.2d 59, 64 (2d Cir. 1983).

96. The better course would be to "specify which disputes are arbitrable and which are not . . . to avoid mandatory arbitration of future disputes . . . [which] would increase transaction costs and complicate negotiations . . . [as] apparently the only means by which parties can unequivocally reserve a future dispute for a court rather than for an arbitrator." Note, supra note 94, at 1153.

Of course, this presupposes that the parties can anticipate and thus provide for all of the potential pitfalls which can develop. This, as any drafter probably will
arbitration: quick and cost efficient resolution of disputes.97

Therefore, the essence of common law arbitration was that the process could be recognized.98 In fact, once the parties had lawfully submitted to arbitration and a final decision had been reached, the result was binding.99 Furthermore, if one of the parties tried to relitigate the issues decided in arbitration, the doctrine of res judicata applied100 and, in appropriate cases, sanctions were imposed, such as recovery of attorney’s fees and costs under Rule 11 of the Federal Rules of Civil Procedure or Rule 38 of the Federal Rules of Appellate Procedure.101

confirm, is virtually an impossible task to accomplish in today’s rapidly changing business and social environment.

97. Malcolm & Segall, supra note 23, at 757-58. The benefits, the authors conclude,

are often meaningless to an investor who initially did not understand the ramifications of his agreement to arbitrate future disputes and who subsequently wants to rescind that agreement because he is less concerned with speed, cost, or forum. In addition, although resort to arbitration might provide some relief from court congestion, this interest should not predominate over the pro-investor policies of the securities laws, particularly in light of the comprehensive congressional and judicial schemes that have been enacted to protect investors’ rights.

Id. at 758.

98. The court in Genesco, Inc. v. T. Kukiuchi & Co., 815 F.2d 840 (2d Cir. 1987) applied a four-part test in deciding whether parties’ disputes should be arbitrated:

First, it must determine whether the parties agreed to arbitrate, . . . second, it must determine the scope of that agreement; third, if federal statutory claims are asserted, it must consider whether Congress intended those claims to be nonarbitrable, . . . and fourth, if the court concludes that some, but not all, of the claims in the case are arbitrable, it must then determine whether to stay the balance of the proceedings pending arbitration.

Id. at 844 (citations omitted).

99. See Note, supra note 94, at 1139. See also Sayre, Development of Commercial Arbitration Law, 37 Yale L. J. at 595, 605 (1928).

100. See discussion infra note 470 and accompanying text. This doctrine bars the readjudication of a matter already decided because there should be an end to litigation. It is a common law concept. Under the Federal Rules of Civil Procedure 8(c), collateral estoppel will also bar a subsequent proceeding even on a different cause of action and in another court (federal or state) because an arbitration award can be pled as an affirmative defense. See Fed. R. Civ. P. 8(c). See also N.Y. Civ. Prac. L. & R. § 3018(b) (McKinney 1974 & Supp.).

101. States are also adopting similar rules relating to the filing of frivolous actions and motions. See, e.g., the New York provision in Part 30 of the Rules of the Chief Administrator, Office of Court Administration, effective January 1, 1989. 347 N.Y. State Law Digest I (Nov. 1988). See also First Investor’s Corp. v. American Capital Fin. Services, Inc., 829 F.2d 307 (9th Cir. 1987) (permitting attorney’s fees and double costs under Rule 38 for an appeal which ignored the law and announced federal policy preference for arbitration and was, therefore, totally frivolous); Robinson v. Dean Witter Reynolds, Inc., Fed. Sec. L. Rep. (CCH) ¶ 94,866 (D.C. Mass. 1989). See also discussion infra notes 512, 843-48 and accompanying text.
I. Common Law Disfavor of Arbitration: Venue Considerations

Historically, the courts were hesitant to remove themselves from jurisdiction over otherwise judicial actions. They were reluctant to enforce predispute arbitration agreements.102

The common law therefore adopted the approach that parties could revoke their agreement to submit to arbitration and request judicial resolution of disputes at any time prior to the arbitrator’s award.103 Typically, this came in a judicial action for a stay of the arbitration. It was difficult for the courts to overturn an arbitration resolution particularly because the parties had voluntarily availed themselves of this process. To overturn an award, common law required certain well-defined grounds: either statutes which forbade arbitration of this type of dispute; judiciously created grounds such as manifest disregard of the law; capriciousness; arbitrariness; or a result against the weight of the evidence.104 Another argument against arbitration, especially of statutory claims, was that the arbitrators are not bound by stare decisis and need not justify or explain their decisions.105 The courts also found that arbitration was inapplicable because of the legislative intent to allow redress by only judicial process, especially in claims involving violation of a statute.106

Courts, therefore, were not responsive to arbitration agreements. It was possible to avoid an arbitration agreement by merely commencing an action in a judicial forum. One explanation for the courts’ hostility is that judges’ salaries were funded by court costs, hence arbitration resulted in no fees to the court. Another plausible explanation is that judges simply wanted control over as much dispute resolution as possible, and they had the power of the state, as opposed to mere contract, at their disposal.107

103. See Note, supra note 94, at 1139.
104. See Robbins, supra note 3, at 25. See also Malcolm & Segall, supra note 23, at 757.
105. See discussion in Ginger, supra note 29, at 519-20.
106. See Kulukundis Shipping Co., S/A v. Amtorg Trading Corp., 126 F.2d 978 (2d Cir. 1942).
107. Id. Kulukundis is cited extensively by Malcolm & Segall, supra note 23, at 728-30. The authors cite several older cases to this effect and several law review commentaries concerning this attitude of the English courts as adopted in
Another reason for judicial hostility was the development of venue concepts. While parties cannot normally select judicial venue, or the place where the dispute will be determined, in arbitration the situs of the determining forum is controlled by the terms of the arbitration agreement. The purpose of venue requirements is to serve the convenience of the parties and witnesses, and thus promote efficient litigation. Unlike arbitration, one of the concerns of venue was the due process rights of defendants. In securities law, this was evidenced by plaintiffs either "forum shopping" or purposely selecting a distant forum with the intent of coercing a weaker defendant into settlement. Unfortunately for brokerage house defendants, the . . . actions are almost universally instituted by 'weak' investors and defended by 'strong' brokerage houses. Consequently, allowing the plaintiff to choose his forum would actually help promote the consumer protection theme espoused by the securities acts.

But if the predispute arbitration clause permits only the selection by the investor between two or more mutually inconvenient forums which are convenient to the broker, it appears that the investor will not be well-protected. The forum for dispute resolution should be accessible to the investor as well as to the broker. Most of the industry arbitrations are located in New York or the paperwork is generated there. Even though arbitrations are held in many cities throughout the nation, a perception of bias is created, especially in the minds of the small investor, by the centralized structure of the arbitration divisions of the marketplace or NASD.

Those characteristics resulted in judicial intolerance toward arbitration. Once a dispute had developed, either party could choose to revoke the predispute agreement and go to court. Although the parties could fashion their own remedial process, it took both sides to decide to go into arbitration, even with a predispute agreement.


108. Judicial venue is dependent on jurisdiction over property or a person.

109. Id. See also Scher v. Alberto Culver Co., 417 U.S. 506, 511 (1974); supra note 91 and accompanying text.

110. The defendant's procedural rights are guaranteed under the fifth amendment of the United States Constitution, which applies in both litigation and arbitration.


112. See Comment, supra note 111, at 408-09 (finding this opposed to congressional "protectionist intent" and therefore "unreasonable" under Zepata's reasoning).

113. See supra note 32 and accompanying text; infra note 580 and accompanying text.

114. Kulukundis Shipping Co., S/A v. Amtorg Trading Corp., 126 F.2d 978,
In 1925, the House of Representatives Report accompanying the Arbitration Act stated:

"The need for the law arises from an anachronism of our American law. Some centuries ago, because of the jealousy of the English courts for their own jurisdiction, they refused to enforce specific agreements to arbitrate upon the ground that the courts were thereby ousted from their jurisdiction. This jealousy survived for so long a period that the principle became firmly embedded in the English common law and was adopted with it by the American courts. The courts have felt that the precedent was too strongly fixed to be overturned without legislative enactment, although they have frequently criticized the rule and recognized its illogical nature and the injustice which results from it. This bill [the Arbitration Act] declares simply that such agreements for arbitration shall be enforced, and provides a procedure in the Federal courts for their enforcement."

The reasons for arbitration in 1925 were similar to those proffered for arbitration today: reduction of court congestion, less expense, quicker resolution, and industry expertise of the arbitrators. Judicial enforcement of arbitration awards was necessary to make securities arbitration an effective procedure in cases involving non-industry litigants. A major advantage of securities arbitration, however, was that the industry could itself enforce arbitration awards through its own process. Obviously, the enforcement sanctions in the securities industry, such as firing an employee or making a firm withdraw from membership on an exchange in the event the award was not met voluntarily, were of little help in dealing with customers over whom the industry had no effective means of policing an award. So for intra-industry disputes, the Arbitration Act was of no great significance to the already existing securities industry practice. Its significance came in the enforcement of industry panel awards through the judicial system.

989 (2d Cir. 1942), distinguished this proposition from Radiator Specialty Co. v. Cannon Mills, Inc., 97 F.2d 318 (4th Cir. 1938), where the defendant after a long pre-trial period moved for compulsory arbitration. The trial court had correctly determined there was a waiver by such action of the defendant who was in default.


116. See also Ginger, supra note 29, at 519.

117. See supra text accompanying notes 43-77 for a further discussion of the economics of arbitration versus litigation.

118. See supra note 78. See also R. Rodman, Commercial Arbitration 6-10 (1984) for a discussion of the speed of arbitration versus court action in the area of securities arbitration.

119. See infra notes 581-83 and accompanying text for a further discussion of the composition of arbitration panels in the securities industry.

120. Otherwise, arbitration would be only duplicative: one would have to relitigate the same issues in court.

121. The decision in arbitration is referred to as an award, rather than a decision or judgment as might be the case in a judicial proceeding.
Accordingly, in order to overcome this predisposition of the courts, both federal and state,\textsuperscript{122} regarding the propriety of arbitration generally (not just in securities industry matters), it became necessary to have legislation authorizing such arbitration. Such statutes normally included a provision regarding judicial enforcement of an arbitration award.\textsuperscript{123}

B. \textit{English Arbitration as Precedent}

As noted above, the English common law was changed by arbitration statutes. As a result, by the turn of the century certain provisions could be waived by the parties in their contract. This included the resolution of disputes in courts. Arbitration was permitted under freedom of contract notions. English courts, however, held waivers into arbitration enforceable only as long as they were not too “tricky.”\textsuperscript{124} The English Companies Act of 1900\textsuperscript{125} compelled full disclosure in the prospectus, and waivers of this right were not permitted as a means of evasion of the statutory requirement in favor of investor full disclosure.\textsuperscript{126} Consequently, direct English precedent indicated that predispute arbitration would not be allowed. Such an agreement would not be recognized despite freedom of contract as it was against the Companies Act provision for an exclusive judicial forum for resolution of securities disputes.

However, because the Arbitration Act was adopted before the securities laws of 1933 and 1934 (despite the securities law’s genesis in the English Companies Act with its forbidding “waiver” of compliance with such laws) the precise scope of nonwaiver in securities actions in the United States was unclear. Is arbitration a “waiver?”\textsuperscript{127} The English

\textsuperscript{122} An example of this predisposition occurred in the recent case of Stroh Container Co. v. Delphi Indus., Inc., 783 F.2d 743 (8th Cir. 1986), where Chief Judge Lay indicated that the initial attractiveness of arbitration has waned with recent experience finding that arbitration often is not simple, inexpensive and expeditious, but rather “complex, expensive and time consuming” and the results “by private and untrained ‘judges’ are distantly remote from the fair process procedurally followed and application of principled law found in the judicial process.” \textit{Id.} at 751 n.12. \textit{See also} Bruff, supra note 102, at 445-47.


\textsuperscript{124} \textit{See} Malcolm \& Segall, \textit{supra} note 23, at 733 (citing Cackett v. Keswick, 2 Ch. 456 (Ch. App. 1902); Greenwood v. Leathershed Wheel Co., 1 Ch. 421 (Ch. App. 1900)).

\textsuperscript{125} \textit{Id.} (citing Companies Act of 1900, 57 & 58 Vict., ch. 58, repealed by Companies (Consolidation) Act of 1908, 8 Educ. 7, ch. 69).

\textsuperscript{126} \textit{See id.}

\textsuperscript{127} \textit{Id.} at 733-34. \textit{See infra} text accompanying note 392 (discussion of waiver).
precedent is of little help due to fundamental differences in their arbitration and companies law.

C. Federal Arbitration Act of 1925

Because the courts were hostile to arbitration, and because of the economic needs of the developing American business world, court dockets became crowded and delays in resolution of business disputes were not unusual. The problem of courts burdened with overcrowded dockets continues despite increasing use of arbitration, but it cannot be doubted that in many respects the tolerance of judges for arbitration has changed considerably over the last 65 years.\(^{128}\)

One important thing to remember is that the Arbitration Act pre-dates the Federal securities laws. The 1933 Act and its progeny, including the Securities and Exchange Act of 1934,\(^ {129}\) Trust Indenture Act of 1939,\(^ {130}\) Investment Company Act of 1940,\(^ {131}\) and Investment Advisor's Act of 1940,\(^ {132}\) were all adopted after the Arbitration Act. This later adoption of the securities laws is one reason for many of the problems arbitration in the securities field has encountered over the last 50 years.

There is no subject matter jurisdiction specified in the Arbitration Act. In confirming arbitration awards under the Federal Arbitration Act, an independent source for federal jurisdiction must be established. The Arbitration Act will not itself provide jurisdiction. In a recent case, for example, a District Court denied a brokerage firm’s petition for confirmation of an award of $46,181, finding that it lacked jurisdiction under the new $50,000 jurisdictional limits for civil actions and that diversity jurisdiction did not exist.\(^ {133}\)

But there is no question that securities transactions are governed by federal law, including the Arbitration Act, under the commerce clause as involving interstate and international commerce and utilizing the medium of the national securities exchanges or traders contacted through facilities of interstate commerce, such as the mails, telephone


\(^{129}\) See supra note 42.


or telegraph. As a result, such transactions clearly fall under the Arbitration Act's provision applicable to any "written provision in . . . a contract evidencing a transaction involving Commerce."\(^{134}\) The Arbitration Act requires a writing, but it is not a statute of frauds provision. As long as the provision is in writing, arbitration is enforceable. This is the case even if the party against whom arbitration is to be compelled has not signed the arbitration provision.\(^{135}\)

As noted above, businessmen were the major impetus for adoption of the Arbitration Act in 1925. They were alarmed at the cost and delays in resolving disputes through the judicial process before 1920.\(^{136}\)


\(^{135}\) This argument is usually not made with customers who will sign the account agreement containing the waiver provision. But it does apply to brokerage employees, who indicate in their employment agreements to be bound by the applicable exchange constitution or rules. See Pearce v. E.F. Hutton Group, Inc., 828 F.2d 826 (D.C. Cir. 1987) (employee claims of defamation and invasion of privacy arising from disclosures of his alleged wrongful conduct in the Hutton cash management scheme which was found violative of mail and wire fraud statutes was properly arbitrated under Uniform Application for Securities and Commodities Industry Representative and/or Agent Agreement (sometimes called U-4 form) of employment which indicated any controversy "shall be settled by arbitration . . . in accordance with the arbitration procedure prescribed in the [NYSE] Constitution and Rules . . . ").

The NYSE Constitution provides that "any controversy between a member . . . and any other person arising out of the business of the member . . . shall be submitted for arbitration . . . " Pearce, 828 F.2d at 828 (citing N.Y.S.E. Const. art. XI, § 1).

If the employee has not filed the U-4 or similar writing indicating agreement to be bound by the rules of an SRO, waiver of right to litigate will not be found. Brown v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 664 F. Supp. 969, 971-74 (E.D. Pa. 1987). In Flink v. Carlson, 856 F.2d 44, 46 (8th Cir. 1988), however, a representative could not be compelled by the brokerage firm to arbitration in the same forum where his customer was raising claims against him and the firm. The customer and U-4 agreements named different arbitral bodies, and the representative's signing the customer agreement as agent of the firm was not sufficient to bind him personally to that forum.

In an interesting case on this issue, Nesslage v. York Sec., Inc., 823 F.2d 231, 233-34 (8th Cir. 1987), the client agreement was with the clearing firm, not the broker who had mishandled the account. The court found that the broker was a third party beneficiary of the margin agreement with the clearing broker and could compel arbitration.

Not all customer agreements provide for arbitration. In such a case NYSE Rule 600(a) provides that a dispute between a customer or non-member and member "shall be arbitrated under the Constitution and Rules of the New York Stock Exchange, Inc. as provided by any duly executed agreement or upon the demand of the customer or non-member." Pearce, 828 F.2d at 828 (citing NYSE Rule 600(a)).

\(^{136}\) See MacCrate, The Legal Community's Responsibilities for Dispute Resolution, 60 N.Y. St. Bar J. No. 8, at 36 (Dec. 1988). MacCrate notes there is a long history of bar involvement in promoting the use of arbitration, beginning in 1914 when the New York State Bar Association created a committee on dispute prevention. This committee's work resulted in the first modern arbitration statute in 1920. In 1920
At that time the American Arbitration Association was not yet in existence. It was formed in 1926 from the Arbitration Society of America which was organized in 1922.137 Some businessmen then, as today, felt it desirable to avoid lawyers and resolve disputes on the basis of an ordinary understanding of what is right and wrong.138 On the other hand, lawyers, like judges, were reluctant to permit a method of resolving disputes outside the law. "Once it became clear to lawyers that they would have a substantial voice in the operation of the new dispute-processing system [the AAA], their opposition vanished and modern commercial arbitration was born."139

Lawyers and businessmen felt arbitration was desireable for the reasons of speed and efficiency. Also, businessmen, at least, desired not only potentially lower legal fees, but also the lack of publicity involved with arbitration—typically arbitration awards and proceedings are not made public, as is the case with the judicial process.

The Arbitration Act provides for the enforcement of predispute agreements in commercial or maritime transactions:140

A written provision in . . . a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

. . . . .

If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.

. . . . . The court shall hear the parties, and upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration . . . .141

Therefore, the Act first validates predispute arbitration agreements as forum selection provisions, and then proceeds to allow the court to

the American Bar Association began drafting the statute which ultimately became the Arbitration Act. In 1926 the AAA was formed from two existing arbitration societies in New York. Id.

137. See F. KELLOR, AMERICAN ARBITRATION 17 (1948).
139. See Shell, supra note 102, at 418 (citing J. AUERBACH, JUSTICE WITHOUT LAW? 104-05, 110 (1983)).
determine the validity of such an agreement. Once it is determined to have been validly entered into, the court cannot act further and must order the matter submitted to arbitration, including compelling the recalcitrant party to submit to such arbitration. Nevertheless, the common law bias still exists. The courts will not compel a party to arbitrate an issue that he or she did not agree to arbitrate.\textsuperscript{142} It is for this reason that some disputes are bifurcated, with some issues determined by arbitration and others judicially. Of perhaps the most importance, however, is that the federal courts must enforce valid arbitration awards.\textsuperscript{143}

One of the advantages to arbitration is the lack of ability to appeal a decision.\textsuperscript{144} In arbitration, there is no appellate process. One may go to the courts after an award, but judicial review is very limited. Such review is subject to the exceptions noted above for manifest disregard of facts or law, prejudice and so forth, which impose such stringent standards for review of an arbitration award that most parties will not have an incentive to do so.\textsuperscript{145} But it also reflects a reason many persons want to arbitrate: the private nature of the proceeding. Arbitration is not public, as is action in court.\textsuperscript{146}

The role of the courts in cases with arbitration agreements is therefore limited to first determining if the requisite intent is present to show agreement to arbitrate and, assuming such intent is found, to next

\textsuperscript{142} See C. D. Anderson & Co. v. Lemos, 832 F.2d 1097 (9th Cir. 1987) (arbitration award had preclusive effect because brokerage firm had waived its right to litigate federal securities law and RICO claims in federal court by submitting those claims to arbitration); Williams v. E.F. Hutton & Co., 753 F.2d 117 (D.C. Cir. 1985); Fortune, Alsweet & Eldridge, Inc. v. Daniel, 724 F.2d 1355, 1356 (9th Cir. 1983).

\textsuperscript{143} See 9 U.S.C. § 9 (1982). See also supra note 123.

\textsuperscript{144} See 9 U.S.C. § 10 (1982). See also supra note 82 and accompanying text for a discussion of judicial review of arbitration awards.

In Jolley v. Paine Webber Jackson & Curtis Inc., 864 F.2d 402 (5th Cir. 1989), and Campbell v. Dominick & Dominick, Inc., 872 F.2d 358 (11th Cir. 1989), recent amendments to the Arbitration Act were found to have precluded the appeal of an interlocutory order granting, continuing or modifying an injunction against an arbitration. See 9 U.S.C.A. § 15(b) (West Supp. 1989) (denying jurisdiction of appeals which seek review of orders granting stays pending arbitration).

However, an order compelling arbitration before the NASD rather than the AAA is final and appealable since it is similar to an order compelling specific performance which is appealable under the new provisions of the Arbitration Act providing that interlocutory orders refusing to compel arbitration are appealable, even though they are not final orders. Thomson McKinnon Securities Inc. v. Salter, 873 F.2d 1397 (11th Cir. 1989).


\textsuperscript{146} One reason arbitration is preferred by brokerage firms is the lack of publicity. This will be less desirable with the new SRO rules regarding publication of awards. But under some dissemination rules, the names of the parties (usually the investor, not the brokerage firm) will not be made public. See infra notes 682-85 and accompanying text.
determining if the dispute is arbitrable. With statutory claims, the court must also determine if the legislative body, Congress in the federal case, intended only to allow the claim to be litigated in the courts or if it intended to permit arbitration.\textsuperscript{147} It must be remembered that "[b]y agreeing to arbitrate a statutory claim, a party does not forego the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than judicial, forum."\textsuperscript{148} The court retains its equitable power to overturn an arbitral award if it is found to be arbitrary or capricious, against the weight of the evidence presented or not in accord with the law.\textsuperscript{149}

As noted above, the Arbitration Act does not itself establish jurisdiction.\textsuperscript{150}

D. Interpretations of Arbitration Act In Securities Cases Prior to McMahon

In a series of recent United States Supreme Court cases, the Court has reviewed the Arbitration Act. The result of these cases has been an unprecedented expansion of the scope of arbitration generally.

In \textit{Southland Corp. v. Keating},\textsuperscript{151} the Supreme Court found the Arbitration Act to be part of the substantive law of the United States, en-

\textsuperscript{147} This is really a question of the intent of the framers of legislation regarding which forum or forums in which they wished claims of the statute's violation to be resolved. Of course, the problem is that in many statutes such legislative intent is lacking. For example, in the 1934 Exchange Act, § 27, exclusive jurisdiction for violations of the Act is in the federal courts, but arbitration is, obviously, not precluded. \textit{See infra} notes 682-85 and accompanying text.

Another dimension of this issue is federal preemption of state law regarding the arbitral process. \textit{See} \textit{General Motors Corp. v. Abrams}, 703 F. Supp. 1103 (S.D.N.Y. 1989) (Federal Trade Commission consent order requiring manufacturer to implement nationwide arbitration program preempts New York Lemon Law which provides consumer a broader remedy of full refund or replacement in some circumstances and requires that the arbitrators be specially trained in the Lemon Law's provisions. New York is not permitted to "work such significant changes upon the manner in which arbitrators arrive at their decisions.").


\textsuperscript{149} \textit{See supra} note 82 (discussing the grounds for judicial review under the Arbitration Act).

\textit{See also} Note, \textit{supra} note 94, at 1138 (when arbitration is part and parcel of the merits of a dispute, the preference of the courts is to permit arbitration of the entire matter because of the court's hesitation to risk collateral estoppel on the merits (citing \textit{Sharon Steel Corp. v. Jewell Coal & Coke Co.}, 735 F.2d 775, 779 (3d Cir. 1984))).

The issue of whether an arbitration clause is enforceable in the context of the dispute itself, for example where arbitration is limited to some of the disputes which might arise but not all, the courts clearly retain the right to determine if arbitration is intended. "This issue, substantive arbitrability, is thus a matter of contract interpretation." \textit{Id.}

\textsuperscript{150} \textit{See supra} note 133 and accompanying text.

acted under the commerce power. Consequently, the federal
preemption doctrine applies and if proper federal jurisdiction is
present, state laws relating to arbitration, or non-arbitration, will not invalid-
ate an arbitration agreement. Two years later, in *Perry v. Thomas* the
Court found congressional intent "to provide for the enforcement
of arbitration agreements within the full reach of the Commerce
Clause." A recent commentator notes:

In a line of pro-arbitration decisions stretching back to 1974, the Court
has transformed the [Arbitration Act] from a procedural statute that
applied only in certain federal cases into a national charter for alterna-
tive dispute resolution.

The Supreme Court took its first step toward reshaping the [Arbitra-
tion Act] into a comprehensive "national arbitration law" in 1983 in
*Moses H. Cone Memorial Hospital v. Mercury Construction Corp.* and its
next step in *Southland Corp. v. Keating.* Thus, state as well as federal
courts are required to enforce the [Arbitration Act] and must refuse
to hear cases that ought to be arbitrated.

As noted above, because Congress adopted the securities laws after
the Arbitration Act, the question remained if Congress intended the

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152. See also *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1 (1983) (holding that the Arbitration Act is the substantive law to be applied in both federal and state courts to any agreement within the coverage of the Arbitration Act).

153. *Southland* involved the arbitration of a dispute under the California Franchise Investment Law, reversing the California Supreme Court's finding that arbitration was not available under that state's statute. *Southland*, 465 U.S. at 17. Similarly, under Iowa's arbitration statute, tort claims are not arbitrable unless there is a separate writing indicating tort claims are subject to arbitration. Tort claims would be included under the *Southland* decision since they are not excluded from § 2 of the Arbitration Act. See Note, *supra* note 94, at 1142 n.44.

154. 482 U.S. 483 (1987). One week after the *McMahan* decision, the Court declared in *Perry* that the Arbitration Act created a body of federal substantive law of arbitrability even if there is state law or policy to the contrary. *Id.* at 489. See *supra* note 152.


The [Arbitration Act] establishes that, as a matter of federal law, any
doubts concerning the scope of arbitrable issues should be resolved in
favor of arbitration, whether the problem at hand is the construction of
the contract language itself or an alleged allegation of waiver, delay, or a
like defense to arbitrability.

*Id.* at 24-25.

Arbitration Act to apply and permit the enforcement of predispute agreements to arbitrate disputes for violations of these laws. Clearly such a result will erode the jurisdiction of the federal courts, which Congress clearly intended to enforce these statutes. But, given congressional preference for arbitration, can this intent be implied? It is this question which Wilko, McMahon and Rodriguez de Quijas struggle to answer.

Consequently, the Arbitration Act must be read in light of the later enactment and perhaps conflicting goals of the securities laws: “Whereas the Arbitration Act was designed to recognize freedom of contract in the area of arbitration agreements, the federal securities laws were designed to protect investors from sophisticated securities dealers.”\textsuperscript{157}

But the real question remains: Why has Congress remained silent regarding the arbitration of securities disputes despite this explosion in litigation? It may be that Congress will answer this question in the near future,\textsuperscript{158} but for now the Supreme Court has resolved the issue by finding in favor of broad Congressional purpose as reflected in the permissible Arbitration Act.\textsuperscript{159}

Actually, as noted in McMahon,\textsuperscript{160} in 1975 Congress did refer to arbitration in the adoption of amendments to the Exchange Act which added to SEC jurisdiction the supervision of industry arbitration procedures.\textsuperscript{161} In language strikingly relevant to today’s market, this Confer-

\textsuperscript{157} See Malcolm & Segall, supra note 23, at 727.
\textsuperscript{158} See infra notes 776-84 and accompanying text.
\textsuperscript{159} Other federal statutes continue this encouragement of arbitration of disputes arising under them. See The Judicial Improvements and Access to Justice Act of 1988, Pub. L. 100-702, which provides for expansion of the pilot court-annexed arbitration from the ten District Courts in which it has been used to another ten Districts and gives congressional blessing to use of compulsory arbitration in cases up to $100,000. This Act became effective November 19, 1988, but the arbitration provisions became effective May 18, 1989. See also N.Y. State Law Digest No. 348 (Dec. 1988).
\textsuperscript{160} 482 U.S. 220 (1987).

The SEC amicus brief in McMahon stated:
[In] light of the Commission’s oversight authority under Section 19 of the Exchange Act, the customer-broker arbitration agreement in this case does not effect a waiver of the protections of the Act and should therefore be enforced. The same conclusion would apply to agreements to arbitrate any federal securities-law claims where the arbitration procedures are subject to the Commission’s section 19 authority . . . [i] to arbitrate pursuant to
ence Report indicated that the securities markets are a major national asset and have flourished under the federal regulation established in the 1930s to provide a share in the profits of the free enterprise system to millions of Americans and a means of raising capital for new and growing business. But the statutory and regulatory structure did not keep pace with economic and technological changes and shifts in investment patterns, with the result

[that there] have been operational breakdowns and economic distortions which have impaired public confidence in the securities markets [which] . . . at times have posed threats to the viability of our entire equity investment system. . . . Unless [the securities markets] adapt and respond to the demands placed upon them, there is a danger that America will lose ground as an international financial center and that the economic, financial and commercial interests of the Nation will suffer.\(^{163}\)

Finding that the basic goals of the Exchange Act are to provide fair and honest mechanisms for the pricing of traded securities; to assure that dealing is fair and without undue preferences or advantages among investors; to ensure efficient transaction costs; and to provide maximum openness and orderliness in the markets, the bill was primarily directed at creation of a national securities market.\(^{164}\) It also modified the position of the exchanges and SROs, created a Municipal Securities Rulemaking Board, coordinated membership in the Securities Investor Protection Corporation, and codified the SEC’s authority to eliminate fixed commission rates, among other things.\(^{165}\) At the end, the Conference Report also noted the amendment to section 28 of the Exchange Act with respect to arbitration proceedings between self-regulatory organizations and their participants, members, and persons dealing with members or participants, was with “the clear understanding of the con-
ferees that this amendment did not change existing law, as articulated in Wilko v. Swan . . . concerning the effect of arbitration proceeding provisions in agreements entered into by persons dealing with members and participants of self-regulatory organizations.”\(^{166}\)

Consequently, Congressional policy on arbitration in 1975 was consistent with the holding in Wilko regarding non-arbitrability of claims arising under section 12(2) of the 1933 Act and, by implication at least,

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\(^{162}\) Conference Report, supra note 161, at 91.

\(^{163}\) Id.

\(^{164}\) Id. at 91-92.

\(^{165}\) Id. at 92-111.

\(^{166}\) Id. at 111.
to claims alleging violation of other provisions of the 1933 Act and the
Exchange Act as well. The SEC recognized this prior position in the
adoption of Rule 15c2-2 which it alluded to in its amicus brief in McMa-
han. 167 But in McMahon the SEC changed its position and supported

See also infra notes 265 and 732 and accompanying text.

This Release indicated that the SEC had taken the position that less than full
disclosure and use of predispute arbitration provisions in customer agreements was
of doubtful validity and had, since 1951, been considered to be a false and
misleading practice, since

all statutes administered by the Commission provide that any condition,
stipulation or provision which binds any person to waive compliance with
their requirements shall be void . . . [and] [t]he question arises, therefore,
whether the result, if not the purpose, of such a [provision] is to create in
the mind of the investor a belief that he has given up legal rights and is
foreclosed from a remedy which he might otherwise have . . . under the
SEC statutes.

Id. (citing Rel. No. 58 (Apr. 10, 1951)).

Interestingly, the economic cost of this regulation was felt by the SEC to be
minimal—having a printer change two or three lines on a customer's account
agreement. Id.

The SEC's reason for promulgating Rule 15c2-2 was to require brokerage
firms to disclose to public investors that they cannot be compelled to arbitrate fed-
eral securities law claims that have been judicially deemed nonarbitrable, notwith-
standing an agreement to arbitrate "any controversy" that exists between the
customer and the brokerage firm.

(adopting Rule 15c2-2). This Release indicated it was a fraudulent, manipulative or
deceptive device for a broker to enter into any agreement with a customer purport-
ing to bind the customer to arbitration of a future dispute arising under the securi-
ties laws. It permitted such agreements which previously existed if the broker sent
disclosure to the customer indicating:

Although you have signed a customer agreement form . . . that states that
you are required to arbitrate any future dispute or controversy that may
arise between us, you are not required to arbitrate any dispute or contro-
versy that arises under the federal securities laws but instead can resolve
any such dispute or controversy through litigation in the courts.

17 C.F.R. § 240.15c2-2(b).

The purpose of this rule was "to ensure that public customers are not misled
concerning" judicial recourse by existing clauses calling for arbitration. It was nec-
essary, the SEC reasoned, due to continued use of the arbitration clause without
noting that it would not, under the law, be applicable to 1933 and Exchange Act
claims. The Commission said, "In light of the clearly contrary law in this area,
such language is a misleading statement of customers' rights under the federal se-
curities laws. Because years of informal discussions have failed to correct this prac-
tice, the Commission has decided that it is appropriate to adopt this rule." Rel. No.

At the same time it adopted this rule, the SEC indicated support for industry-
sponsored arbitration and recognized the Uniform Code of Arbitration as provid-
ing an efficient and economical procedure for dispute resolution.

Rule 15c2-2 required a procedural notice clause but did not create any sub-
arbitration.

E. Wilko v. Swan

Before the Supreme Court decided *Wilko* in 1953, there had been no cases interpreting the Congressional intent between the securities laws and arbitration in disputes claiming violation of such investor-protective provisions.

In *Wilko* a customer brought a cause of action for violation of section 12(2) of the 1933 Act for alleged misrepresentations and omissions, claiming the brokerage firm account representative had falsely led him to purchase common stock by misrepresenting its value. The false representation was that the stock would be valued at $6.00 per share over the then current market price pursuant to a soon to be announced merger agreement and that sophisticated investors were then buying the stock for speculative profit. The brokerage firm did not even file an answer to the complaint, but moved for stay of litigation in the Federal courts under the margin agreement arbitration clause the customer had signed in opening the account, and under the Arbitration Act.

The Supreme Court held that the 1933 Act reflected congressional intent in favor of judicial enforcement in federal court. Since section 12(2) changed the prior common law principle of *caveat emptor*, the Court found a "special right" was created in the purchasers of securities under the statute and that it was drafted "with an eye to the disadvantages under which buyers labor." The statute was found to


169. *Id.* at 429. This is very similar to the touting of stocks as "takeover candidates" by brokers.
170. *Id.*
171. 9 U.S.C. § 3 (1982). *See supra* note 12 and accompanying text. The *Wilko* court also noted that the customer agreement further stated that the brokerage firm was relieved of all liability for all "representation or advice by you or your employees or agents regarding the purchase or sale by me of any property ..." *Wilko v. Swan*, 346 U.S. 427, 434 (1953). This language, read in conjunction with the 1933 Act's emphasis on full and fair disclosure for the protection of investors, seems most damming. The decision, therefore, to find the congressional intent to put buyers of securities on the same basis as other purchasers, especially when there is inequality in bargaining position, seems only fitting. *Id.* at 435.
172. The Court in *Wilko* stated the rationale this way: "As the protective provisions of the Securities Act require the exercise of judicial direction to fairly assure their effectiveness, it seems to us that Congress must have intended Section 14 ... to apply to waiver of judicial trial and review." *Id.* at 437.
173. *Id.* at 435. *See Comment, supra* note 22, at 364 (for a discussion of the
expressly give a securities buyer a judicial remedy for his protection. Thus the 1933 Act prevailed over the 1925 Arbitration Act because under section 14 of the 1933 Act any "condition, stipulation, or provision binding any person to waive compliance with [the 1933 Act] . . . shall be void" and an arbitration clause was construed as a "stipulation" under the statute.

The Supreme Court in Wilko expressed concern about securities industry arbitration procedures at the time. First, they found arbitrators had no judicial instruction from a judge regarding the law they were to apply in the arbitration cases they heard. The Court felt this was particularly significant since the securities laws provisions are not the same as "[d]etermination of a quality of a commodity or the amount of money due under a contract . . . " Issues such as "material fact," or "reasonable care" were being determined without the securities laws' meaning being applied by the arbitrators. Second, because a derivation of this concept of "special right"). See also Comment, supra note 156, at 207-08, which determined that Wilko found three "unique" attributes to § 12(2) which create this "special right":

First . . . the buyer does not carry the burden of proving the seller's scienter as required in a common law fraud action. There is a rebuttable presumption . . . that the seller knew, or in the exercise of reasonable care should have known, that the information given to the buyer was inaccurate or incomplete [(once the buyer establishes the misrepresentation or omission of material fact)]. The seller must overcome this presumption by proving his lack of scienter to avoid liability. Second, a plaintiff has broad discretion in selecting a forum under the 1933 Act because both state and federal courts have jurisdiction over § 12(2) claims, and a claim filed in state court may not be removed to federal court. Finally, § 14 of the 1933 Act prohibits any agreement that would serve as a binding waiver of compliance with any provision of the Act.

Id. at 208 (citations omitted).

174. 15 U.S.C. § 77n (1982). See Fletcher, supra note 29, at 402-04 (regarding congressional policy concerning predispute waivers of provisions of the 1933 Act). Fletcher notes that there is a substantial difference between the 1933 Act and Exchange Act and the other securities laws (see supra notes 130-32): all others prohibit waiver of compliance with SEC orders. Id. at 403 n.72.

See also Annotation, Construction and Application of § 14 of Securities Act of 1933 (15 USCS § 77n) and § 29(a) of Securities Exchange Act of 1934 (15 USCS § 78cc(a)), Voiding Waiver of Compliance With Statutory Provisions or Rules or Regulations, 26 A.L.R. Fed. 495 (1976).


176. See Cain, Commercial Disputes and Compulsory Arbitration, 44 Bus. Law. 65, 69-70 (1988) (pointing out that although these reasons were given by the majority in Wilko, the dissent argued that no facts supported these conclusions). See also Wilko, 346 U.S. at 436 U.S. at 436-37.

177. The Court specifically mentioned the lack of instruction and possible misconception with the "legal meaning of such statutory requirements as 'burden of proof,' 'reasonable care,' and 'material fact.'" Wilko, 346 U.S. at 436. See Malcolm & Segall, supra note 23, at 736, 755-57.


179. Justice Jackson, concurring in the Wilko result, nevertheless believed that
record of the proceedings is lacking, questions regarding burden of proof, admissibility of evidence, and the like were difficult for the courts to supervise. 180 Third, judicial power to vacate an award was limited by the Arbitration Act 181 and, fourth, some awards were never subject to court review. 182

The basic premise of section 12(2) of the 1933 Act was that a person is liable to a buyer of securities if he sells or offers through interstate commerce, makes an untrue statement, or omits to state a material fact, and the purchaser is unaware of the omission or untruth. Further, the 1933 Act also specifies that the investor-buyer need only prove the omission or untruth, and thereafter the burden of establishing that the buyer did know or, in the exercise of reasonable care, should have known of such omission or misstatement, falls on the seller of the security.

This shift of the difficult burden was one of the major reasons the Wilko Court determined congressional intent to support non-arbitration. Another was the nationwide venue and service provision under

there could be a judicial remedy for the arbitrator's error in interpretation of the relevant statute. Id. at 438-39. The majority had determined that without a written record, such a review would not be possible. Id. at 439. But an even more convincing statement of the right of judicial review is contained in Justice Frankfurter's dissent. "There is nothing in the record before us, nor in the facts of which we can take judicial notice, to indicate that the arbitral system . . . would not afford the plaintiff the rights to which he is entitled." Id. Frankfurter concluded that the plaintiffs could be given all the rights to which they are entitled under the securities laws in arbitration. Id. (Frankfurter, J., dissenting).

He further stated, "Arbitrators may not disregard the law. Specifically they are . . . 'bound to decide in accordance with the provisions of section 12(2).'. . . [T]heir failure to observe this law 'would * * * constitute grounds for vacating [an] award [under section 10 of the Arbitration Act].'" Id. at 440 (Frankfurter, J., dissenting) (citation omitted).

180. The argument that judicial direction is necessary, as well as judicial review, is made in Comment, Arbitration of Securities Claims: Policy Considerations For Keeping Investor-Broker Disputes Out of Court, 1 COLUM. BUS. L. REV. 527, 539-41 (1987).

181. Section 10 of the Arbitration Act limits the district court's power in vacating an arbitration award to those situations set forth supra in note 82. Under section 10 (e) the court can in such cases direct a rehearing by the arbitrators upon vacating an award, which, of course, one would assume would not occur in the event of some misconduct or prejudice by the arbitrators.


The 1933 Act did not provide exclusive federal court jurisdiction; claims could be brought in state courts as well. See infra note 187.

182. See Malcolm & Segall, supra note 23, at 756-57, noting that because arbitration awards do not require reasons there is little consistency, and they can lead to haphazard results in a system which is thereby arcane and unpredictable. And due to the lack of a reviewable record it is virtually impossible to determine if the process is fairly treating investors or properly interpreting securities law. The article concludes that the result "seems to conflict directly with the pro-investor policies underlying the federal securities laws." Id.
section 12(2). A third was the reasoning that arbitration is ill-suited to protect "unwary buyers from unscrupulous sellers." "Moreover, the Wilko Court contended that Congress specifically designed this 'special right' to reduce the disparity in bargaining power between buyers and sellers inherent in the open securities market." The Court concluded that "[w]hile the Securities Act does not require [a claimant] to sue, a waiver in advance of a controversy stands upon a different footing." The Wilko result was adopted by Professor Louis Loss in the American Law Institute's Federal Securities Code which protects small investors against predispute waiver of the right to court determination of securities law claims. This decision was also justified by finding that despite the congressional policy decision in enacting the Arbitration Act that it could trade off judicial protection for the decreased court congestion, time, expense, and increased expertise which might result from industry arbitration, arbitration was not permitted. In any event, it is clear that under Wilko only predispute agreements were invalid; an agreement to arbitrate after a dispute had arisen would be enforceable.

F. Wilko's Progeny

For twenty-six years Wilko stood for the proposition that 1933 Act claims are not arbitrable. This principle has been eroded in a series of cases, culminating in the overturning of Wilko in Rodriguez de Quijas, de-

183. Id. at 730-31.
184. Id. Wilko, 346 U.S. at 435-36.
185. Comment, supra note 156, at 208. The Court in Wilko said:
[I]t is clear that the [1933 Act] was drafted with an eye to the disadvantages under which buyers labor. Issuers of and dealers in securities have better opportunities to investigate and appraise the prospective earnings and business plans affecting securities than buyers. It is therefore reasonable for Congress to put buyers of securities covered by that Act on a different basis from other purchasers.
Wilko, 346 U.S. at 438. See also supra note 163 and infra note 224 and accompanying text.
186. Wilko, 346 U.S. at 438.
187. 2 FED. SEC. CODE § 1725 (1980). This provision exempts the "sophisticated investor" along with the other Wilko exceptions. See Fletcher, supra note 29, at 429-31 (discussing the need for protection in arbitration of the small investor, versus the large or institutional (and thereby "sophisticated") investor with bargaining power to influence the waiver of litigation decision). The Federal Securities Code envisions a court determining if the investor truly has the financial and legal knowledge and bargaining position to be considered "sophisticated." 2 FED. SEC. CODE § 1725(b)-(3)(c) (1980). See also supra notes 65 and 94 and accompanying text.
188. See Fletcher, supra note 29, at 407.
189. See supra note 86 and accompanying text.
cided in the 1989 term.\textsuperscript{190}

In 1972 the Second Circuit found that the sale of securities in a private placement not involving an exchange transaction was clearly within the meaning of commerce under the Arbitration Act.\textsuperscript{191} The same result would probably result in almost any sale of securities, due to the use of the securities markets, NASDAQ trading, telephones or the mails.\textsuperscript{192} Therefore, federal arbitration will render state arbitration statutes inapplicable to securities disputes.\textsuperscript{193}

Dents were made in Wilko’s armor for the last 15 years of its 25 year life. In 1974 the Supreme Court in Scherk decided that international securities arbitration was permissible.\textsuperscript{194} The Court determined that facilitating international trade was preferable to an expansive application of the securities laws by holding that Wilko prohibited Exchange Act claims arbitration. Because the Exchange Act claim under section 10(b) was subject to an implied private right of action, whereas section 12(2) of the 1933 Act had created an express statutory right of action, the Court felt justified in permitting international arbitration. But the basis of the Scherk decision was the international business aspects, which the Court found different from those controlling in Wilko.\textsuperscript{195} The forum selection in arbitration was controlling, “absent a strong showing that it should be set aside.”\textsuperscript{196} The Court in Scherk also said in dictum that a “colorable argument” was made that Wilko was not controlling in cases under the implied action provisions of the Exchange Act because of the jurisdictional and remedial differences between the 1933 and Exchange Acts.\textsuperscript{197}

The next Supreme Court case interpreting Wilko came in 1985. In Dean Witter Reynolds, Inc. v. Byrd,\textsuperscript{198} a claim for trading in a customer’s account was made under the Exchange Act and various state provisions. Dean Witter, the broker, did not ask for a stay, but did request

\textsuperscript{190} See text infra at notes 267-94 discussing Rodriguez de Quijas.


\textsuperscript{192} Fletcher, supra note 29, at 402.

\textsuperscript{193} Id.


\textsuperscript{195} Scherk, 417 U.S. at 513-17.

\textsuperscript{196} Id. at 518 (finding forum-selection in an international contract valid and rejecting the previous doctrine that international forum selection would not be respected by United States courts unless the forum was more convenient than the state in which suit was brought (citing The Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 15 (1971))).


\textsuperscript{198} 470 U.S. 213 (1985).
an order severing pendent state claims and requiring arbitration for them.\textsuperscript{199} The Court refused to determine whether \textit{Wilko} was applicable to Exchange Act claims.\textsuperscript{200} Instead, it found that bifurcated proceedings, which would result if the arbitration agreement were enforced as to state claims, was what Congress had intended in the Arbitration Act, even if the result is "piecemeal" litigation.\textsuperscript{201}

Therefore, \textit{Byrd} held that it is proper to compel arbitration of pendent arbitrable claims, even where the result would possibly be inefficient bifurcated proceedings in different forums,\textsuperscript{202} finding this was the result of the preeminent concern of Congress in passing the Arbitration Act.\textsuperscript{203}

\textit{Byrd} caused confusion in the lower courts as to the continued application of \textit{Wilko} to 1934 Act violations.\textsuperscript{204} Several courts interpreted \textit{Byrd} to hold mandatory arbitration clauses unenforceable.\textsuperscript{205} In an interesting case involving claims under \textit{RICO},\textsuperscript{206} the Third Circuit distinguished those claims which were based on section 10(b) of the Exchange Act holding them not arbitrable, while claims under \textit{RICO} for mail fraud and wire fraud were, nevertheless, arbitrable.\textsuperscript{207}

One commentator explained the result of this bifurcated procedure and noted:

a) When faced with the necessity to arbitrate state claims \textit{and} litigate federal . . . claims . . . , it may be advisable to discontinue the arbitration and proceed only on the federal claims, to avoid . . . larger legal fees.

b) Where the arbitration proceeding is conducted first and the customer is fully compensated . . . Section 28 of the [Exchange Act] would presumably preclude further recovery in the subsequent federal litigation.

c) Where the customer has proven liability to an arbitration panel but [only recovers part of the damages sought], the broker-dealer may

\textsuperscript{199} Dean Witter assumed that the federal securities claim was not subject to arbitration. \textit{Id.} at 215.

Justice White concurred, noting that the Exchange Act "does explicitly provide a private right of action to victims of certain illegal conduct." \textit{Id.} at 225 n.* (White, J., concurring).

\textsuperscript{200} \textit{Id.} at 216 n.1. The Court waited two years to decide the issue in \textit{Shearson/American Express, Inc. v. McMahon}, 482 U.S. 220 (1987).

\textsuperscript{201} \textit{Byrd}, 470 U.S. at 221.

\textsuperscript{202} \textit{Id.} at 217.

\textsuperscript{203} \textit{Id.} at 221.

\textsuperscript{204} See Note, \textit{Securities Arbitration—The Supreme Court Resolves the Issue of Enforceability of Mandatory Arbitration Clauses in Broker-Investor Contracts}, 78 \textit{Iowa L. Rev.} 449, 461 n.112 (1988). Commentators were also confused due to the anti-waiver provisions of both securities statutes.

\textsuperscript{205} See \textit{id.} at 462.

\textsuperscript{206} See supra note 5.

\textsuperscript{207} Jacobson \textit{v. Merrill Lynch, Pierce, Fenner & Smith, Inc.}, 797 F.2d 520 (9th Cir. 1986).
be encouraged to settle . . . in lieu of subjecting the same facts to a
jury.

d) Where the customer loses in arbitration, he or she may not want to
pursue the more expensive and time consuming process of federal
litigation.208

The result of this procedure appears to be bifurcation at its most
absurd. Neither the goals of investor protection nor the efficiencies
inherently associated with arbitration were furthered by the decision in
Byrd.

In 1985 the Supreme Court also decided Mitsubishi Motors Corp. v.
Soler Chrysler-Plymouth.209 That case held that an agreement to arbitrate
antitrust claims in an international commercial agreement was enforce-
able.210 Prior decisions had indicated the contrary with respect to anti-
trust claims in general.211 The rationale was similar to that used in the
security arbitration area—the public interest in antitrust enforcement
is better served by the courts than by arbitration.

In Mitsubishi an agreement on the sale of inventory to Soler, a large
Puerto Rican car dealer, called for arbitration in Japan. Mitsubishi
sought arbitration by court order in a breach of contract action against
Soler, and Soler counterclaimed against Mitsubishi and Chrysler Inter-
national alleging conspiracy to restrain trade under the antitrust
laws.212

The Supreme Court in Mitsubishi, as it had in Scherk, focused on the
international aspects of the transaction, but raised questions regarding
the standards applied in American Safety without reversing it.213 The
Court found an “emphatic federal policy in favor of arbitral dispute
resolution.”214 In fact, the opinion reads as an endorsement of arbitra-
tion, further undermining Wilko.

[A]daptability and access . . . are hallmarks of arbitration. The antici-
pated subject matter of the dispute may be taken into account when the
arbitrators are appointed, and arbitral rules typically provide for the
participation of experts. . . . [T]he factor of potential complexity also

44-45 (1986).
210. For information concerning international arbitration see W. CRAIG, W.
PARK & J. PAULSSON, INTERNATIONAL CHAMBER OF COMMERCE ARBITRATION (2 ed.
1985).
211. See American Safety Equip. Corp. v. J. P. Maguire & Co., 391 F.2d 821 (2d
Cir. 1968). The court found antitrust cases to be very complex and felt the judicial
process was perhaps better suited to deal with this type complex litigation. The
court also noted that since the antitrust laws were to be enforced against business
and because arbitrators were typically business persons, perhaps industry
arbitration was not in the public interest. Id. at 827-28.
212. 473 U.S. at 618-19.
213. Id. at 629-32.
214. Id. at 631.
does not persuade us that an arbitral tribunal could not properly handle an antitrust matter.\textsuperscript{215}

These cases set the stage for the \textit{McMahon} and \textit{Rodriguez de Quijas} decisions, which probably came as no surprise to those familiar with the earlier decisions. The Court had consistently concluded over the last 15 years that arbitration of claims created by other federal statutes was adequate as an alternative to protect the rights of those covered by the laws, if not preferred as a less costly, more efficient means of resolving these claims.

\section*{IV. \textit{McMahon}}

By 1987, as a result of these decisions, confusion reigned in the federal courts regarding the standard to be applied in determining if predispute arbitration agreements in cases raising securities law claims were enforceable and a stay of litigation was required to permit resolution in a non-judicial forum. The Supreme Court’s \textit{Wilko} and \textit{Byrd} decisions were seemingly consistent, but the Court had clearly sent forth the message that arbitration under the Exchange Act may not be governed by the \textit{Wilko} prohibition. It had merely refused to say so expressly.\textsuperscript{216}

A majority of courts had adhered to \textit{Wilko} as far as 1933 Act claims were concerned; and most concurred in the same result for Exchange Act claims as well. For example, in \textit{Wolfe v. E.F. Hutton \& Co.}\textsuperscript{217} the Eleventh Circuit expressly extended \textit{Wilko} to Exchange Act 10(b) claims implied as a private right of action under a series of cases dealing with Rule 10b-5. It based this decision on four grounds:\textsuperscript{218} (1) the refusal of the Supreme Court to limit \textit{Wilko} to 1933 Act claims; (2) both Acts provide a “special right” to investors; (3) the exclusive federal jurisdiction under section 27 of the Exchange Act was a more important safeguard for the investor than the concurrent jurisdiction of both federal and state courts in the enforcement of the 1933 Act under 1933 Act section 14;\textsuperscript{219} and (4) the express right of investors to sue under the 1933 Act was implied to exist in Exchange Act proceedings by a long line of precedent which Congress had not overturned, even in the 1975 amendments to the Exchange Act.\textsuperscript{220}

\begin{flushright}
\textsuperscript{215} \textit{Id.} at 633-34. \textit{See also} Comment, \textit{supra} note 156, at 218 n.92 (discussing Justice Stevens’ dissenting opinion in \textit{Wilko} expressing the view that arbitration should be limited to those claims arising out of the parties’ contract, not from claims arising from federal statutes).
\textsuperscript{216} For a discussion of both the majority and concurring opinions reserving the decision on whether the 1934 Act and section 10(b) required arbitration under \textit{Wilko} see sources cited \textit{supra} note 197.
\textsuperscript{217} 800 F.2d 1032 (11th Cir. 1986).
\textsuperscript{218} \textit{See} Comment, \textit{supra} note 156, at 209-10.
\textsuperscript{219} \textit{See} \textit{supra} note 187 and accompanying text.
\textsuperscript{220} For a discussion of the 1975 amendments, see \textit{supra} note 167 and
A similar rationale had been applied to RICO actions. Courts inferred that Congress intended to entrust the enforcement of RICO to the courts and not to arbitrators.\footnote{See, e.g., S.A. Mineracao Da Trindade-Samiti v. Utah Int'l Inc., 576 F. Supp. 566 (S.D.N.Y. 1983).} "Surprisingly, most courts . . . mechanically accepted this rationale without debate."\footnote{Comment, supra note 156, at 213 (footnote omitted); contra Greenblatt v. Drexel Burnham Lambert, Inc., 763 F.2d 1352 (11th Cir. 1985). "Whether a RICO claim is a 'non-arbitrable federal claim' is an open question in [the Eleventh Circuit]." Id. at 1361.}

Hence, \textit{Wilko, Scherk,} and \textit{Byrd} had created a vague body of law on the issue of whether section 10(b) precluded arbitration of a broker-investor contract containing a mandatory predispute arbitration clause. This set the stage for \textit{McMahon}. First, regarding the question of enforceability of broker-investor arbitration agreements, for the \textit{Wilko} Court, the touchstone was the presence or absence of a 'special right' in the language or legislative intent of the applicable provision of the 1933 Act, under an argument it dubbed the 'colorable argument.' That special right was supplied by section 12(2) of that Act, which provides that an aggrieved party may bring an action directly against a perpetrator of securities fraud.\footnote{Comment, supra note 156, at 213 (footnote omitted); contra Greenblatt v. Drexel Burnham Lambert, Inc., 763 F.2d 1352 (11th Cir. 1985). "Whether a RICO claim is a 'non-arbitrable federal claim' is an open question in [the Eleventh Circuit]." Id. at 1361.}

The issue of the distinction between customer remedies for violation of the securities laws being express or implied was decided in \textit{McMahon}.\footnote{223. Comment, \textit{Securities Arbitration—The Supreme Court Resolves the Issue of Enforceability of Mandatory Arbitration Clauses in Broker-Investor Contracts: Shearson/American Express, Inc. v. McMahon}, 73 IOWA L. REV. 449, 460-61 (1988).}

\textit{McMahon} also resolved an issue concerning the power of arbitrators to award punitive damages.\footnote{224. Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987).} In \textit{McMahon} the Court found that RICO mandated treble damages and fee recovery under Arbitration Act authority. Still, state courts may resist these extraordinary remedies.\footnote{225. See \textit{Shell}, The Power to Punish: Authority of Arbitrators to Award Multiple Damages and Attorneys Fees, 72 MASS. L. REV. 26 (1987); Stipanowich, Punitive Damages in Arbitration: Garrity v. Lyle Stuart, Inc., Reconsidered, 66 B.U.L. REV. 953 (1986). See accompanying text infra note 688 for an examination of the question of an arbitration award of punitive damages.}

Legislation may be required to overcome this resistance.

\section{The McMahon Facts}

In 1984 the Mahons brought suit in federal court for losses of approximately $500,000 against Shearson/American Express, Inc., a brokerage firm with whom they had several accounts, and the Shearson registered representative who handled their accounts.\footnote{See Shell, supra note 102, at 417 n.125.} The com-
plaint alleged the representative made false statements and omitted material facts in giving them advice and that the representative had churned their accounts. All the alleged acts were in violation of (1) state fraud and breach of fiduciary duty statutes, (2) section 10(b) of the Exchange Act and Rule 10b-5, and (3) RICO, which would allow treble damages and recovery of attorney’s fees and costs.228

The McMahons had signed contracts with Shearson upon opening their account which contained predispute arbitration clauses.229 Shearson moved to compel arbitration. Under the authority of Byrd, the district court ordered arbitration of the state claims and 10(b) claim, but not the RICO claim.230 Both parties appealed. The Second Circuit held the district court erred in ordering arbitration of the 10(b) claim,231 but affirmed on the RICO and state claims disposition.232

See Comment, supra note 79, at 1397. The McMahons were successful funeral home operators who had pension plans and other savings of over $1 million when the account representative, a fellow parishioner in their church, persuaded them to invest on the promise that she could boost their income 25 percent. Id. at 1397 n.180.

Based on their holdings, the McMahons would be considered “sophisticated” investors under SEC Rule 215, which looks for $1 million net worth and income of over $200,000 in the two years prior to a purchase in private placements. See T. Hazen, The Law of Securities Regulation §§ 4.13-4.20 (Law. Ed. 1985). This would be ridiculous, however, since the McMahon’s net worth was probably not in connection with securities trading, but their business. See Comment, supra note 22, at 368-69 n.233.

228. See infra note 688 and accompanying text for a discussion of the right to punitive damages; supra note 5 for discussion of RICO.

229. The relevant clause in McMahon stated:

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 in accordance with the rules, then in effect, of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchange, Inc. as I [the customer] may elect.


230. 618 F. Supp. 384, 387 (S.D.N.Y. 1985) (refusing to compel arbitration of RICO under the thesis that Congress had created a Wilko-type “special right” for which only federal court enforcement would be permitted).

231. The Second Circuit found the policy concerns expressed in Wilko about protecting investors applicable to the McMahons’ claims.

The court declared that churning claims contain broad public interest because churning claims deter future fraudulent conduct. The Second Circuit concluded that ‘the similarity of the non-waiver provisions [of the 1933 Exchange Acts] . . . as well as the strong public policy concern inherent in the securities laws and the legislative history that preceded their enactment, support the compelling need for a judicial forum. . . .’


Shearson appealed to the Supreme Court and certiorari was granted in order to resolve the conflict among the courts of appeals regarding the arbitrability of section 10(b) and RICO claims.\textsuperscript{233}

B. McMahon’s \textit{Holding}

In a 5-4 decision, made more obtuse by the concurring opinions, the Court reversed the Second Circuit and remanded the dispute to arbitration. The Court thus found that implied actions under the Exchange Act and securities claims under RICO were arbitrable.\textsuperscript{234} But the narrow and splintered majority, reversing the longstanding \textit{Wilko} rationale, left many questions. Five Justices agreed that implied actions under the Exchange Act were arbitrable under the rationale of \textit{Byrd, Scherk} and \textit{Mitsubishi}, and all Justices agreed that RICO securities claims were also arbitrable under the “public policy” exception of \textit{American Safety}. Justice Stevens wrote a short concurrence and dissent on the “longstanding interpretation” of \textit{Wilko} for 10(b) issues.\textsuperscript{235} Justice Blackmun also dissented on the 10(b) issue and was joined by Justices Brennan and Marshall.\textsuperscript{236}

Justice O’Connor, writing for the majority, began by noting the Arbitration Act’s creation of a strong federal policy favoring arbitration.\textsuperscript{237} She found that even when claims are grounded in federal statutes, the burden is on the party seeking to avoid arbitration to establish congressional intent to provide an exception to the Arbitration Act’s presumption of arbitrability.\textsuperscript{238} The burden was not met in \textit{McMahon} for either implied rights of action under the Exchange Act or RICO, despite the plaintiffs’ contention that the nonwaiver provisions of section 29(a) of the Exchange Act\textsuperscript{239} were similar to the provisions in

\textsuperscript{233} The Court found RICO involved a fundamental federal public policy which would not be permitted to be resolved in an arbitral forum. \textit{Id.} at 98-99.
\textsuperscript{234} \textit{McMahon}, 482 U.S. at 238. \textit{See supra} text accompanying note 223.
\textsuperscript{235} \textit{Id.} at 268 (Stevens, J., concurring and dissenting). Justice Stevens found that the congressional intention in 1975 was not to overturn \textit{Wilko}, but an implied acceptance of non-arbitrability for both 1933 and Exchange Act violations. This position was rejected by the bare majority of the Court. But Justice Steven’s cogent argument stressed the desirability of judicial restraint because it is preferable to have Congress expressly overturn a prevailing judicial interpretation of longstanding application by the courts which had given the statutes a clear meaning. \textit{Id.} at 268-69.
\textsuperscript{236} \textit{See infra} note 257-59 for a discussion of Justice Blackmun’s dissent.
\textsuperscript{237} \textit{See supra} note 152 and accompanying text discussing the caselaw leading to \textit{McMahon} and a discussion of \textit{Cone}.
\textsuperscript{238} This can be done by showing some legislative history, textual provision, or an inherent conflict with the Arbitration Act and the federal statute under which the claim is made. For example, RICO did none of the above. Thus, the Court found RICO claims arbitrable. \textit{See McMahon}, 482 U.S. at 242.
\textsuperscript{239} Section 29(a) provides: “Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or
section 14 of the 1933 Act,\textsuperscript{240} which the Wilko Court had found persuasive. Moreover, Justice O'Connor clearly adopted a revisionist approach and wrote that Wilko was not a simple reading of the 1933 Act's nonwaiver provision, but could be understood only "in the context of the Court's ensuing discussion explaining why arbitration was inadequate."\textsuperscript{241} Noting that decisions subsequent to Wilko had rejected the "general suspicion of the desirability of arbitration and the competence of arbitral tribunals,"\textsuperscript{242} and the 1975 Exchange Act amendments giving the SEC power to supervise industry arbitration rules,\textsuperscript{243} she concluded that "[a]n arbitration agreement does not effect a waiver of the


\textsuperscript{241} McMahon, 482 U.S. at 239.

\textsuperscript{242} Id. at 235-36.

\textsuperscript{243} Id. at 236-37. Justice O'Connor found that the language of the House Report on the 1975 amendments did not remotely address the subject of arbitration, and may have gone to the decision in Scher. Id. at 234. Or if it did, it probably went to support other explanations other than the non-arbitrability of Exchange Act claims as the McMahons proposed. Id.

One commentator noted regarding this SEC supervision:

Pursuant to § 19 of the Exchange Act, 15 U.S.C. § 78s (1982), the SEC has long been able to exercise broad regulatory authority over securities exchanges and other self-regulatory organizations (SROs). However, in 1975, Congress amended § 19 to expand that authority to cover all SRO rules. Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 19, 89 Stat. 97, 146. The Commission now believes, in light of the amendment, that it has "the power to ensure that arbitration procedures prescribed by the SROs are adequate to enforce the rights of customers against brokerage firms that are members of SROs." It should be noted, however, that the SEC's ability to police the securities markets has recently been called into question.

Malcolm & Segall, supra note 23, at 744 n.138 (citations omitted).


protections of the [Exchange] Act."\textsuperscript{244} Arbitration was thus found "an adequate substitute" for a judicial forum, particularly so since it was not a "substantive right" under \textit{Scherk}. The right to select a judicial forum exists only where arbitration is inadequate to protect the substantive rights at issue.\textsuperscript{245} Remarkably, the Court did \textit{not} either define what constituted a substantive right or overturn \textit{Wilko}.\textsuperscript{246}

Thus, the Court rejected \textit{Wilko} as it applied to implied actions under the Exchange Act by finding that the "suitability of arbitration as a means of enforcing Exchange Act rights is evident"\textsuperscript{247} and that "the mistrust of arbitration that formed the basis for the \textit{Wilko} opinion in 1953 is difficult to square with the assessment of arbitration that has prevailed since that time."\textsuperscript{248} This rationale will probably extend the "new" circumstances of securities arbitration to the 1933 Act as well: \textit{Wilko} was truly imperiled.\textsuperscript{249} An arbitration clause will be an enforecable stipulation requiring a party to waive his or her right to trial.\textsuperscript{250}

\begin{footnotes}
\item 244. \textit{McMahon}, 482 U.S. at 229. \textit{McMahon} thus concluded that \$ 27 of the Exchange Act is procedural and not substantive, therefore it can be waived. \textit{Id.}
\item 245. Note, supra note 205, at 466.
\item 246. \textit{McMahon}, 482 U.S. at 229. As noted above, the Court expressly did \textit{not} overturn \textit{Wilko}, although that was the effective result in \textit{Scherk} according to the concurring opinion of Justice White in \textit{Scherk}, which was cited as the major rationale for the \textit{McMahon} conclusion. Several commentators, joining Justices Blackmun and Stevens, have questioned this reliance on \textit{Scherk} by Justice O'Connor. \textit{Scherk}, remember, relied on an international business exception to the application of United States securities laws, and assumed that 10(b) would apply \textit{Wilko}'s prohibition of arbitration. See infra note 257-59 for a discussion of Justice Blackmun's dissent.
\item 247. \textit{McMahon}, 482 U.S. at 232. The Court points out that in \textit{Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth}, 473 U.S. 614, 628-37 (1985), they had examined arbitration and concluded: (1) such forums were capable of handling factual and legal complexities; (2) streamlined procedures do not restrict substantive rights; and (3) judicial review, though limited, suffices to ensure compliance with the statute. \textit{Id.} The Court, however, did not distinguish between the \textit{international} commercial aspects of \textit{Mitsubishi} and the fact that the Mahons were consumers far less sophisticated than the large dealer and manufacturer in \textit{Mitsubishi}.

The Court did not address the issue that because there was no written opinion in arbitrations, less sophisticated investors would be less well protected from unfair practices in market transactions. See \textit{Wilko v. Swan}, 346 U.S. 427, 431 (1953).

In addition the Court noted: (1) \textit{Scherk} was precedent, although in an international agreement, for 10(b) claims being arbitrable; (2) the courts would enforce arbitration between members of an SR\textsuperscript{O} of 10(b) claims; and (3) \textit{Wilko} does not apply to post-dispute agreements to arbitrate. \textit{McMahon}, 482 U.S. at 232-34.
\item 248. \textit{McMahon}, 482 U.S. at 233. The Court also noted that arbitration now adequately protects investors, apparently focusing on the SEC oversight provided after the 1975 Exchange Act amendments. \textit{Id.} But this does not seem logical, as Justice Blackmun points out. See also infra note 255 and accompanying text.
\item 249. See infra text accompanying notes 265-90. It seems clear that the Court read \textit{Wilko} very narrowly, finding it held arbitration agreements unenforceable under the Arbitration Act only when arbitration is inadequate to enforce the substantive rights created by the federal statute.
\item 250. See Note, supra note 231, at 804-05.
\end{footnotes}
A similar analysis was applied to find that RICO's congressional intent also fell under the Arbitration Act's strong public policy. As noted above, the Justices all agreed that RICO claims were subject to arbitration. Arbitration could serve the interest of Congress in its "remedial and deterrent function," except in the criminal sense. In "run-of-the-mill civil RICO claims brought against legitimate [business] enterprises," the Justices suggested mandatory arbitration was appropriate.

The dissenting Justices agreed with the majority's analysis of the Arbitration Act's preference position, but disagreed on the Exchange Act claims arbitrability. Justice Blackmun first argued that congressional action in amending the Exchange Act in 1975 to provide for SEC supervision of arbitration procedures of the SROs was not as clear a repudiation of the judicial interpretation of the substantive or procedural rights of investors as the majority had decided.

251. McMahon, 482 U.S. at 240 (quoting Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, 437 U.S. 614, 637 (1965)).
252. *Id.* at 242.
253. *Id.* at 242-43 (Blackmun, Brennan, and Marshall, JJ., concurring in part and dissenting in part); *id.* at 268-69 (Stevens, J., concurring in part and dissenting in part).
254. Justice O'Connor found that the express reference to the non-affect in the Conference Report of Wilko did not extend it beyond the 1933 Act because (1) it would do so by enacting a law if it wanted Wilko applicable to Exchange Act claims and (2) the Conference Report may have wished to make clear either the 1975 amendments to the Exchange Act did not affect the 1933 Act or really the Congress was approving Scherk. *Id.* at 237-38. (One commentator noted this was an unusual justification, since Congress would have expressly referred to Scherk if it had meant to do so. *See Arbitration, supra* note 243, at 284 n.31.)

Section 28(b) of the Securities Exchange Act of 1934 was amended in 1975, as follows:

(b) Nothing in this Chapter shall be construed to modify existing law with regard to the binding effect (1) on any member of or participant in any self-regulatory organization of any action taken by the authorities of such organization to settle disputes between its members or participants, (2) on any municipal securities dealer or municipal securities broker of any action taken pursuant to a procedure established by the Municipal Securities Rulemaking Board to settle disputes between municipal securities dealers and municipal securities brokers, or (3) of any action described in paragraph (1) or (2) on any person who has agreed to be bound thereby.


The Conference Report stated:

The Senate bill amended § 28 of the Securities Exchange Act of 1934 with respect to arbitration proceedings between self-regulatory organizations and their participants, members, or persons dealing with members or participants. The House amendment contained no comparable provision. The House receded to the Senate. It was the clear understanding of the conferees that this amendment did not change existing law, as articulated in *Wilko* . . . , concerning the effect of arbitration proceeding provisions in agreements entered into by persons dealing with members and participants of self-regulatory organizations.
Justice Blackmun argued *Wilko* had not been decided on the Court’s belief that inadequacy of arbitration was insufficient for enforcement of 1933 Act claims. He centered on the almost identical non-waiver provisions of the two securities laws. Justice Blackmun concluded that due to the investor protection purposes of the statute and because the laws are part of a comprehensive and integrated federal regulatory scheme for governing securities transactions, arbitration of either 1933 or Exchange Act claims, including those which the courts have recognized to exist by implication from the statutory purpose, still fails to protect the investor adequately. Justice Blackmun still had concern similar to that expressed in 1953 in *Wilko* in three areas: (1) there was still very limited judicial review of arbitration awards; (2) arbitrators need not rely on judicial precedent or make a record; and (3) the industry-sponsored forum selections gave no real alternative to the investor and were probably not effectively supervised by an already overworked SEC.

Justice Blackmun also questioned the SEC’s change in position regarding arbitration. Citing the rationale justifying the adoption of Rule 15c2-2, Justice Blackmun was unable to dismiss, as did the majority, the belief that *Wilko* did not bar the enforcement of predispute arbitra-


255. McMahon, 482 U.S. at 256. See supra note 239 and infra notes 268-90 and accompanying text.

256. Id. at 259-61. Justice Stevens also dissented on this issue finding that:

Gaps in the law must, of course, be filled by judicial construction. But after a statute has been construed, either by this Court or by a consistent course of decision by other federal judges and agencies, it acquires a meaning that should be as clear as if the judicial gloss had been drafted by the Congress itself.

Id. at 268. Justice Stevens concluded that “any mistake that the courts may have made in interpreting the statute is best remedied by the Legislative not the Judicial Branch.” Id. at 268-69. (Stevens, J., concurring in part and dissenting in part).

257. Id. at 259 n.17.

258. Id. at 265-66. Justice Blackmun indicated that the SEC was already overworked and that the SEC only has power to approve the SROs own rules and not rulemaking authority. Id.

Chairman Ruder testified to the Senate Appropriations Committee for the 1990 budget that while there has been a “dramatic increase” in regulatory activities, while the staff has only slightly increased, so that the Commission does not have the necessary resources to “engage in adequate enforcement.” Fed. Sec. L. Rep. (CCH) No. 1333, at 8 (Apr. 12, 1989). Kathryn B. McGrath, Director of the Division of Investment Management, commented at a 1988 Mutual Funds and Investment Management Conference that “more money and staff for the SEC is ‘pie in the sky’ [because] staff was cut 11% . . . although the workload has grown.” Fed. Sec. L. Rep. (CCH) No. 1331, at 6 (Mar. 29, 1989). See also Daily Rep. for Executives (BNA), No. 143c-6, at C11 (July 7, 1988) for comments of SEC General Counsel Daniel Goeizer.

259. See supra note 167 and infra note 732 and accompanying text.
tion agreements dealing with violations of the "special rights" created by the securities laws.

C. Analysis of McMahon: Future Issues

Clearly, McMahon stands for the continued expansive reading of the Arbitration Act goals. Both the dissent and the bare majority holding in McMahon on the issue of whether Wilko should be expanded to the Exchange Act, gave an expectation of a Wilko reversal. Justice Stevens dissent on the issue of Congressional action to overturn the long line of cases applying Wilko, coupled with the strong statements regarding the present state of arbitration by Justice Blackmun, indicates that the state of arbitration claims for securities violations is not clearly permissive. The Court took an expansive position, but it is arguable that the 5-4 majority could switch in future decisions, especially with the retirement of Justice Powell. In any event, the Court through Justice Stevens' opinion had clearly set the stage for Congress to announce its true intention regarding predispute arbitration agreements in the securities field.

The question prior to Rodriguez de Quijas was whether the Court would adopt the interpretation of federal securities statutes under the "ignore Congressional inaction" approach of Justice O'Connor, the "inferred approval by Congressional inaction" approach of Justice Stevens, or the "enactment rule" of Justice Blackmun. Both dissents would require express Congressional action to overturn a long-established judicial precedent. This inconsistency is nothing new with the Rehnquist Court and, as a result, the lower courts had little guidance.

In another harbinger of what was to come from the Supreme Court's review of Wilko in Rodriguez de Quijas, the Supreme Court on March 3, 1989 announced its decision in a case where a contract provided a choice of law provision which when applied would stay arbitration. The Court, in a 6-2 decision, decided that this stay under state law was permissible under the Arbitration Act. Chief Justice Rehn...

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261. See Arbitration, supra note 243, at 290 (citing cases adopting each of these three positions in the interpretation of various statutes other than the securities laws). But see Fletcher, supra note 83, at 114, 115-16 ("There can be no question about the fact that Wilko was wrongly decided. The holding was based on a flawed methodology of statutory interpretation and has represented bad policy since its decision.").

V. RODRIGUEZ DE QUIJAS

After McMahon the confusion with respect to the arbitrability of claims under the Exchange Act and under RICO seemed resolved. But what remained of Wilko? While McMahon did not overrule Wilko, it is obvious that the view of the Supreme Court toward arbitration had undergone striking change since 1953. As a result, there was a split in the federal courts regarding the non-arbitrability of section 12(2) claims, the very issue in Wilko. A number of investors added 12(2) allega-

Justices Brennan and Marshall dissented on the ground that a state court decision should not "effectively nullify a vital piece of federal legislation." Id. at 1262.

263. See Moulin, supra note 41, at 374-84.

264. See, e.g., Osterneck v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 841 F.2d 508, 512-13 (3d Cir. 1988) which states:
As long as Wilko stands in the Supreme Court, agreements to arbitrate claims under the Securities Act of 1933 will remain unenforceable, but that is the only rule Wilko now stands for. . . . [S]ection 507 of the Pennsylvania Securities Act, when applied to preclude arbitration that falls within the Federal Arbitration Act, 'stands as an obstacle to the accomplishment are execution of the full purposes and objectives of Congress' . . . and is therefore preempted.

Id.

"After examining the factors considered by the Court in Wilko, the only distinction between the two claims which has any merit is that implied rights of actions are different from specifically granted statutory causes of action." Lusardi, Enforcement of Arbitration Agreements In Securities Fraud Disputes, 41 Rutgers L. Rev. 541, 570 (1989).

See also Nesslage v. York Sec., Inc., 823 F.2d 231, 234-35 (8th Cir. 1987) (holding 10(b) and civil RICO claims are arbitrable under the McMahon decision, but pointing out that 12(2) claims still are not arbitrable pursuant to Wilko); Rosenblum v. Drexel Burnham Lambert, Inc., 700 F. Supp. 874 (E.D. La. 1987) (since substantive rights at issue in 1933 Act claims are adequately protected by arbitration, McMahon requires that court compel arbitration); Adams v. Merrill Lynch, Inc., Fed. Sec. L. Rep. 27 (CCH) ¶ 93,741 (W.D. Okla. 1988); Kavours v. Visual Prod. Sys., 680 F. Supp. 205, 207 (W.D. Pa. 1988) ("Our review of McMahon leaves us with the conviction that Wilko is now untenable."); Staiman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 673 F. Supp. 1009 (C.D. Cal. 1987) (Although McMahon did not involve a 1933 Act claim, and the Court did not expressly overturn Wilko, it appears to this court that McMahon so seriously undermined Wilko’s rationale that [the plaintiff’s] 1933 Act claims . . . must be sent to arbitration."); Smith v. Merrill Lynch, Inc., 700 F. Supp. 1092, 1095 (S.D. Fla. 1987) ("The Court in McMahon refused to overrule Wilko for reasons of stare decisis. Thus, while the reasoning behind Wilko has been cut away, its bare holding remains in force. Accordingly, this court is bound to follow the Wilko holding and refrain from compelling arbitration
tions to their complaints against broker-dealers hoping to avoid the required arbitration in *McMahon* despite Justice Blackmun's suggestion in *McMahon* that *Wilko* was placed in the "graveyard of ideas." 265

In 1988, on an appeal of arbitration in a section 12(2) case, the Court granted certiorari 266 and, in 1989, decided *Rodriguez de Quijas v. Shearson/American Express, Inc.* 267 The Court's decision answered many of the *McMahon* questions.

A. *The Rodriguez de Quijas Facts*

This case involved a group of Texas investors who suffered losses in an account opened at a local Shearson office. They brought action for their losses based on unauthorized and fraudulent trading including violation of the antifraud provisions of section 12(2) and other provisions of the 1933 and Exchange Acts which all parties agreed to be subject to arbitration under *McMahon*. The district court ordered all claims, except those under section 12(2), to arbitration. The Fifth Circuit in *Rodriguez de Quijas* found that *McMahon* had effectively undercut every aspect of *Wilko* making it "obsolete." It found that "[a]uthority no
longer exists to deny arbitration of the § 12(2) claims . . . . Arbitration must be directed as to both the Securities Act claims and Exchange Act claims." Judge Williams based this conclusion on reading Wilko as "barring waiver of a judicial forum only if arbitration is inadequate to protect the substantive rights at issue." He further noted that McMahon made it clear that the Supreme Court, as a result of advances in arbitration since Wilko, no longer felt arbitration inadequate to protect substantive rights of investors. Due to the similarities between section 14 of the 1933 Act and section 29(a) of the Exchange Act, both of which void any stipulation "to waive compliance with any" provision of the statutes, the Fifth Circuit felt Congress did not intend to draw such a "fine distinction" to prohibit arbitration in one and not the other.

The Supreme Court again came out in favor of arbitration. With the retirement of Justice Powell, replaced by Justice Kennedy who supported arbitration as a circuit court judge, there appeared little doubt that the final nail was about to be driven into Wilko's coffin.

B. The Rodriguez de Quijias Holding

This opinion by Justice Kennedy, again a 5-4 decision, expressly overruled Wilko and held that arbitration of securities law violations of section 12(2) of the 1933 Act was permissible. From McMahon's holding, there resulted inconsistency and violation of the principle that the securities acts should be construed harmoniously or as a part of an integrated system of regulation, since they "constitute interrelated components of the federal regulatory scheme governing transactions in securities." Thus the Court has further embraced arbitration: Federal and state courts are mandated to enforce predispute arbitration agreements for all claims under the federal securities laws.

The Court found that the current judicial view favors arbitration and rejected Wilko's outmoded "judicial hostility to arbitration," and its concern regarding procedural issues. It absolutely rejected once

268. 845 F.2d at 1299.
269. Id. at 1298 (citing Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 229 (1987)).
270. Id. (citing Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 234 (1987)).
271. 845 F.2d at 1299. "[S]imilarities between the Securities Act and the Exchange Act outweigh any differences between them." Id. (citing Sibley v. Tandy Corp., 543 F.2d 540, 543 n.3 (1976)).
272. Id. (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)).
again the idea that the securities acts, because they were enacted after the Arbitration Act, indicated congressional intent to not subject claims to arbitration. Finding Wilko concerned primarily with the procedural protections of litigation, the Court concluded, in light of the SEC’s recently expanded authority “to oversee and regulate those arbitration procedures,” the Wilko rationale no longer existed. But, perhaps even more significantly, the Court found that “the right to select the judicial forum and the wider choice of courts [so important to Wilko’s justification] are not . . . essential features of the [1933 Act].”

After reviewing the decisions over the last 14 years that stressed the validity of arbitration, Justice Kennedy concluded Wilko was obviously not correct because “the language prohibiting waiver of ‘compliance with any provision of this title’ could easily have been read to relate to substantive provisions of [the 1933] Act without including the remedy provisions.” Despite its affirmance of the Fifth Circuit’s decision, the Court’s opinion nevertheless chastised the Fifth Circuit for its impertinence in usurping the Court’s “prerogative of overruling its own decisions” and forgetting its duty to follow the direct precedent.

While concluding that there was no reason to treat claims under the 1933 Act differently from those brought under the Exchange Act, the Court bound itself by the strong language of the Federal Arbitration Act’s mandate that “arbitration agreements ‘shall be valid, irrevocable, and enforceable.’” The Court, however, still left open the possibility of challenge to arbitration on the grounds of fraud or duress, or by a showing of “overwhelming economic power that would provide grounds for the revocation of any contract,” although in Rodriguez de Quijas there was no showing in the record of such defenses to arbitration.

Finally, the opinion overruled Wilko retroactively by finding such retroactivity would not “produce ‘substantial inequitable results’. . . [because] our assessment that resort to the arbitration process does not inherently undermine any of the substantive rights afforded to petitioners under the Securities Act.”

The dissenters too found the Fifth Circuit had engaged in “indefen-

274. 109 S. Ct. at 1921 (citing Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987)).
275. Id. at 1919.
276. Id. (Stevens, J., dissenting) (citing Alberto-Culver Co. v. Scherk, 484 F.2d 611, 618 n.7 (7th Cir. 1973), rev’d, 417 U.S. 506 (1974)).
277. Id. at 1921-22.
278. Id. at 1921 (citing Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987)).
279. Id.
280. Id. at 1920 (citing Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 628 (1985)).
281. Id.
sible . . . judicial activism,"282 but found that although the Court is not subject to the same restraint as lower courts in upsetting its prior decisions, to do so in the face of “3 1/2 decades” of Congressional acceptance of Wilko is to usurp the lawmaking responsibility of Congress. Finding “valid policy and textual arguments on both sides regarding the interrelation of federal securities and arbitration Acts,”283 the dissenters did not agree that this area of the law which had been settled for so long should be upset by judicial action in the face of Congressional acceptance.

C. Rodriguez de Quijas Analysis

Both 12(2) and 10(b) claims and the waiver provisions of section 14 and section 29(a) are so similar that it was hard to conclude any other result would occur, especially looking at the case law developments up to McMahon. McMahon made it clear that the Court no longer considered arbitration as inadequate to protect substantive rights and the advances in arbitration procedures, particularly SEC oversight, apply equally to protection of the substantive rights under both the 1933 and Exchange Acts.284 One commentator, however, agreed with the Rodriguez de Quijas dissenters that McMahon was a result of judicial activism: reversing a longstanding judicial statutory interpretation that Congress seemed purposely to have left intact.285 Finding, as did Justice Stevens in McMahon,286 that there was no “gap” in the law to be filled by judicial construction due to the meaning Wilko had acquired from 25 years of judicial “gloss,” this commentator felt that “the judiciary should not undertake the ongoing role of making policy determinations in a changing world.”287 Further, “Congress should have exclusive power to overturn [such] a judicial statutory interpretation.”288

Consequently, the Rodriguez de Quijas holding is important for a number of reasons. First, predispute arbitration agreements will be enforced by the Federal courts to compel arbitration of both 1933 and Exchange Act claims unless there is a showing of the invalidity of the contract under a very narrow group of theories. Second, the Court em-

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282. Id. at 1923 (Stevens, J., dissenting, joined by Brennan, Marshall and Blackmun, JJ.).
283. Id.
285. See Arbitration, supra note 243, at 281 (reviewing McMahon). Finding that the Court in recent years has interpreted Congressional silence inconsistently, this note concludes: “[T]he Court [should] avoid decisions like McMahon, in which a narrow majority’s views on a discrete policy issue result in the reversal of a longstanding judicial statutory interpretation that Congress has left intact.” Id. at 290. See also Shell, supra note 102, at 410-13, 432.
286. See supra note 241 and accompanying text.
288. Id. at 288.
phatically rejected any denigration of the arbitration process as unfair or inadequate, specifically noting that any judicial "suspicion of arbitration . . . has fallen far out of step with [the Court's] current strong endorsement of the federal statutes favoring this method of resolving disputes." 289 Third, the Court suggested that due to the preeminence of the Arbitration Act, Rodriguez de Quijas should be applied retroactively even to those cases brought in federal courts under the prior holding in Wilko. The result has been court mandated arbitration in a number of pre-Rodriguez de Quijas cases. 290

Both McMahon and Rodriguez de Quijas make the same basic assumption: That arbitration as a procedure can offer as much protection to the claimant as litigation in the federal courts. There is criticism of this assumption, and to date there is little concrete evidence to support the position that in reality this is true. The Supreme Court has clearly taken the position that securities arbitration is fair to investors.

VI. WHAT'S NEXT?

For those few cases still in litigation regarding arbitration and the Exchange Act, McMahon and Rodriguez de Quijas have been retroactively applied 291 under both the Rodriguez de Quijas mandate and under application of the usual rule that federal cases are decided in accordance with the law as it exists at the time of decision and not as it exists at the time of filing. 292 One recent case found that "strong federal policy in favor of arbitration—and the absence of any federal policy favoring securities litigation—suggests that the rule [in McMahon] should be ap-


291. See, e.g., Villa Garcia v. Merrill Lynch, Inc., 833 F.2d 545 (5th Cir. 1987); Smokey Greenhaw Cotton Co. v. Merrill Lynch, Inc., 805 F.2d 1221 (5th Cir. 1986) (RICO claims were subject to arbitration under McMahon despite a number of years in litigation prior to the McMahon decision) cert. denied, 482 U.S. 928 (1987).

292. See Rodriguez de Quijas, 109 S. Ct. at 1922 (citing St. Francis College v. Al-Khazraji, 481 U.S. 604, reh’g denied, 483 U.S. 1011 (1987); United States v. Schooner Peggy, 5 U.S. (1 Cranch) 103, 109 (1801); Chevron Oil v. Huson, 404 U.S. 97, 106-107 (1971) (Court will limit decision to prospective application in appropriate cases; otherwise retroactive application is the rule)).

See also Villa Garcia, 833 F.2d 545, wherein the court explained its view of retroactive: "The new law is applied prospectively—that is, to decisions handed down after the new law is announced—but it has retroactive effects, because for a time parties come before the courts with controversies that unfolded while the old
plied retroactively."

Furthermore, McMahon and Rodriguez de Quijas "alter only the forum for resolving [the] dispute and not [the plaintiff's] substantive rights." In a typical maneuver, the plaintiff in a recent case, Ferreri v. First Options of Chicago, Inc., filed a securities cause of action after an arbitrator had determined damages. The court held that arbitration "provide[d] a fair, complete and adequate substitute for a judicial trial" because (1) the arbitrators had expertise in the securities industry, a specialized field; (2) the plaintiff's economic loss was resolved from the evidence in a complete proceeding; (3) plaintiff was represented by his own lawyer at the arbitration, but changed lawyers to pursue litigation after the arbitration was complete; and (4) the rules and procedures used in arbitration were substantially the same as those used at trials. The court also noted that the damages recoverable for the arbitrated claim were the same as those recoverable for the violations of securities laws. This will be the result in most arbitrable cases.

A. State Law

In a case decided just before Rodriguez de Quijas, however, the Supreme Court may have opened the door to further litigation. A construction contract predispute arbitration clause was read in conjunction with the choice of law provision and was found to be governed by a state law which did not permit arbitration of the issues in controversy.

See also Bradley v. Richmond School Bd., 416 U.S. 696, 715 (1973), id. at 547 n.16 (quoting Noble v. Drexel Burnham Lambert, Inc., 823 F.2d 849, 850 n.2 (5th Cir. 1987)).

Bradley v. Richmond School Bd., 416 U.S. 696, 715 (1973) ("[E]ven where the intervening law does not explicitly recite that it is to be applied to pending cases, it is to be given recognition and effect."); King v. Drexel Burnham Lambert, Inc., 825 F.2d 68 (5th Cir. 1987); Mayaja, Inc. v. Bodkin, 824 F.2d 439 (5th Cir. 1987), on remand, 107 S. Ct. 2332 (1987) (McMahon's position on RICO was also retroactively applied); Ketchum v. Prudential-Bache Sec., Inc., 710 F.Supp. 300 (D.C. Kan. 1989); Kavouras v. Visual Prod. Sys., 680 F. Supp. 205, 207 (W.D. Pa. 1988) ("Wilko is now untenable. The non-waiver provisions of the two Acts are substantially the same... "); Aronson v. Dean Witter Reynolds, Inc., 675 F. Supp. 1324 (S.D. Fla. 1987) (1933 Act claims submitted to arbitration); Goldberg v. Drexel Burnham Lambert, Inc., No. 83 C 8586 (N.D. Ill. Dec. 16, 1987) (LEXIS 11782) (the court distinguished between margin account activities and cash account, where margin agreement provided for arbitration and cash did not, finding parties' intention at the time agreements were entered into could not have supposed the McMahon result regarding arbitration of Exchange Act claims).

294. Id. at 851; See Rodriguez de Quijas, 109 S. Ct. at 1922.
296. Id. at 1187.
297. A written transcript was referred to by the Court in determining that the arbitrators had detailed evidence provided by the plaintiff. Id.
298. Id. at 1187-88.
The Supreme Court agreed with the stay of arbitration and denied the argument that the Arbitration Act preempted state law because the agreement provided that state law would govern.

In another case, a court found that under state securities statutes a nonarbitrable right of action was created for trading by brokers. Other claims proceeded to arbitration, but this issue was to be litigated without stay because the outcomes under the different statutes would not be dispositive of each other.

B. Arbitration in Non-Securities Areas

To date, the Supreme Court has not confronted the non-arbitrability of securities issues in connection with other laws as have the federal circuit courts. For example, in Bird v. Shearson Lehman/American Express, Inc., it was determined that arbitration could be compelled against participants in an employee retirement plan. Beneficiaries of an ERISA plan could be compelled to arbitrate any issue or "controversy arising out of or relating to" the trust by the trustee's agreement with the broker. However, the court bifurcated the resolution of issues regarding violation of ERISA into those which could not be bargained away and those which were purely contractual claims. The ERISA statutory scheme was found to provide exclusive jurisdiction in the federal courts once a claim created as a part of the statutory rights was raised. The dissent, however, found little difference between ERISA and the securities laws and would have compelled arbitration of all issues.

VII. Arbitration Generally

A. Common Law Arbitration

Because arbitration in the securities industry refers a dispute to an impartial person or persons chosen by the parties in advance of the dispute, its jurisdiction arises from, and is based on, voluntary agreement of the parties or on their contract. Furthermore, any disinterested person can serve as an arbitrator.

Arbitration has been called the "oldest known method of settlement

301. 871 F.2d 292 (2d Cir. 1989).
303. Bird, 871 F.2d at 297-98.
304. Id. at 298-300 (Cardamone, J., dissenting).
306. See Comment, Arbitration—Competency of Arbitrators, 25 St. John's L. Rev. 337, 339 (1951) (noting that a corporation or governmental agency can not serve even with consensus of the parties).
of disputes." 307 King Solomon used arbitration; 308 Roman law recognized arbitration agreements; 309 and mythology evidences arbitration precedents. 310 Therefore, in many cases the preference for arbitration centers on the "ancient concepts of freedom of contract." 311

The intent of the parties in predispute arbitration agreements is to achieve a final disposition of a future dispute in an easier, more expeditious and less expensive manner than litigating such a dispute. The goal is to avoid the formalities, delay and expense of the judicial dispute resolution process. 312

Contracts are interpreted applying a "plain meaning" to the language the parties chose to use. Consequently, the typical commodities customer agreement which clearly specifies that arbitration "applies to all disputes arising between the parties" 313 will extend the application of the contract beyond those pertaining to the account's activities. For example, an options agreement will include, under its arbitration provisions, regular cash account trading under a customer contract which would not contain an arbitration clause. 314

Due to the contractual basis of arbitration, the question in enforceability of an arbitration agreement in any given case gives rise to the question of whether it was agreed to voluntarily. If not, the courts will not find a meeting of the minds of the parties and consequently the arbitration clause will be void. So, for example, if a party that has been

309. 5 R. POUND, JURISPRUDENCE 360 (1959).
310. See Emerson, supra note 308, at 156.
312. Zapata, 407 U.S. at 3-6. The Court cited many cases for the proposition that the parties' intent in the contract containing a predispute arbitration clause should result in very limited judicial review of the arbitration process and award. Id.
314. Gilmore, 668 F. Supp. at 320. Again, this is the permissive reading of the Arbitration Act at work. But see Azriliant v. Shearson Lehman American Express, Inc., [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,393 (S.D.N.Y. 1987), where the court held that the customer should be able to chose not to arbitrate when some of his accounts had predispute arbitration clauses and others did not. The court used normal construction rules and decided the contract against the broker who drafted the agreements. Id.

See also Cotter v. Shearson Lehman Hutton Inc., 126 F.R.D. 19 (S.D.N.Y. 1989) (court held authorized options trading in plaintiff's accounts is within arbitration clause for determination by arbitrators, not the court).
compelled to accept an arbitration clause in an agreement is acting under a disability or is incapacitated, the entire contract can be void or voidable under general principles of contract law.\textsuperscript{315} This, of course, also means that those who are not parties to the contract can not be forced to arbitrate a dispute\textsuperscript{316} any more than those parties who have not unequivocally consented to arbitrate.\textsuperscript{317} For example, if there is controversy regarding the capacity of a party or the intent of the parties regarding a contract containing an arbitration clause, these issues can be resolved by the judicial process. If the requisite intent is present, the court will find the voluntary agreement to arbitrate mandates submission to arbitration as defined in the contract.\textsuperscript{318} Written arbitration agreements do not need to be signed to be enforceable.\textsuperscript{319}

Federal courts utilize a four-part examination to determine whether a case is arbitrable when there is a predispute arbitration agreement between the parties. The same test is applicable in state determinations on motions to stay the legal proceedings pending arbitration. The questions asked are:

(1) Did the parties agree to arbitrate?

(2) What is the scope of the agreed arbitration?

\textsuperscript{315} It is interesting to note that the differences between federal and state law will apply here. For example, the claim that an arbitration agreement clause was fraudulently induced may be determined by the court, but if the court determines it was not so induced, the question whether the entire contract was induced by fraud is one for the arbitrator’s determination. See Prima Paint Corp. v. Flood & Conklin Mfg., Co. 388 U.S. 395 (1967); Adler v. Rimes, 545 So.2d 421, 422, reh’g denied (Fla. App. 4th Dist. 1989); RESTATEMENT (SECOND) CONTRACTS § 12 (1979).

\textsuperscript{316} See R. Rodman, supra note 305 at 13-15. But see Antinoph v. Laverell Reynolds Sec., Inc., 703 F. Supp. 1185 (E.D. Pa. 1989) (introducing broker was not a party to customer in agreement with clearing broker and as such, could not enforce the arbitration provision of that contract).

\textsuperscript{317} R. Rodman, supra note 305, at 14-16.

\textsuperscript{318} The question under § 4 of the Arbitration Act relates to the entire contract, not the issue of arbitration. See R. Rodman, supra note 305, at 296; Krebsbach & Friedman, infra note 329, at 17.

\textsuperscript{319} See Middlebrooks v. Merrill Lynch, Inc., Fed. Sec. L. Rep. (CCH) ¶ 94,399 (N.D. Ala. 1989) (citing several cases including Genesco, Inc. v. T. Kakiuchi & Co., 815 F.2d 840, 846 (2d Cir. 1987) which stated:

As to the unsigned forms it is well-established that a party may be bound by an agreement to arbitrate even absent a signature . . . . Further, while the [Arbitration Act] requires a writing, it does not require that the writing be signed by the parties. . . . Thus, the district court did not err in finding that in this long standing and on-going relationship Genesco agreed to arbitrate disputes arising under the unsigned sales confirmation forms as well.

Genesco, 815 F.2d at 846.

(3) If statutory claims are asserted, did the legislature intend these claims to be nonarbitrable?

(4) If not all claims asserted are arbitrable, can there be bifurcation or should there be a stay of litigation pending arbitration? 320

Further, if the parties have indicated their agreement to arbitration of a dispute after it has arisen, the courts are uniform in enforcing arbitration. 321

1. Contract of Adhesion Defense

One of the major arguments against the mandatory arbitration provisions in contracts is the "contract of adhesion" defense. 322 Under this defense it is argued that the courts should not enforce a predispute agreement to submit to arbitration rather than the courts because of public policy. The public policy argument centers on fairness 323 and unconscionability. 324 There is nothing inherently unfair or oppressive

320. Robbins, supra note 34, at 47.
321. This is also true in the securities industry. As noted above, not all brokerage house customer agreements contain mandatory predispute arbitration clauses. Of those that do not, securities arbitration will still be available after the dispute arises. An agreement to submit an existing dispute to arbitration is binding. See Moran v. Paine, Webber, Jackson & Curtis, 389 F.2d 242 (3d Cir. 1968); Gardner v. Shearson, Hammil & Co., 433 F.2d 367 (5th Cir. 1970), cert. denied, 401 U.S. 978 (1971).
323. See A. Corbin, Corbin on Contracts (1960 & 1980 Supp.) which stated:
Finding a contract to be one of adhesion means nothing more than the court must review its terms for fairness . . . .
To be fair, a contract of adhesion must not give one party all the benefits while giving the other party all of the burdens of the contract.
Id. § 559F, at 331 (citations omitted).
See also Weaver v. American Oil Co., 257 Ind. 458, 276 N.E.2d 144 (1971) which stated:
When a party . . . show[s] that the contract, which is . . . to be enforced, was . . . an unconscionable one, due to a prodigious amount of bargaining power on behalf of the stronger party, which is used to the stronger party's advantage and is unknown to the lesser party, . . . the contract provision, or the contract as a whole, if the provision is not separable, should not be enforceable on the grounds that the provision is contrary to public policy.
Id. at 464, 276 N.E.2d at 148; see also U.C.C. § 2-316 (U.L.A. 1989); Restatement (Second) of Contracts § 177 (1979).
about arbitration clauses.\textsuperscript{325} Finding a contract one of adhesion is, however, not determinative. This will only permit the court to examine the fairness of its terms.\textsuperscript{326} If found to be oppressive applying this standard, the arbitration provision will be invalidated as oppressive.\textsuperscript{327}

The courts have developed the adhesion theory "[t]o ameliorate the harsh consequences resulting from the enforcement of [contracts which contain] oppressive or unexpected terms."\textsuperscript{328} Adhesion contracts have two elements. First, they are drafted by a stronger party and the weaker party, or "adhering" party, has no opportunity to negotiate any of the substantive terms.\textsuperscript{329} Second, the adhering party has no realistic opportunity to look elsewhere for the goods or services needed. In essence, due to the nature of the marketplace there is no freedom of contract as far as the adhering party is concerned. He is "required by the realities of business" to use the standard-form contract that the stronger party requires.\textsuperscript{330}

(S.D.N.Y. 1985). In that case the court held that although the contract of adhesion existed, the agreement was enforceable because it was not unconscionable or violative of public policy. See Robbins, supra note 3, at 42.

Restatement (Second) of Contracts § 208 takes the position that contracts of adhesion are not unenforceable unless they are unconscionable. Restatement (Second) of Contracts § 208 comment d. Federal courts have consistently taken the position that arbitration agreements are not, as a matter of law, unconscionable. See also citations in Securities Indus. Ass'n v. Connolly, 703 F. Supp. 146, 153 n.11 (D. Mass. 1988), aff'd, 883 F.2d 1183 (1st Cir. 1989). As long as the arbitration clause is commercially reasonable and plaintiffs have a reasonable opportunity to understand it, it will not be unconscionable. Pierson v. Dean Witter Reynolds, Inc., 742 F.2d 334, 339 (7th Cir. 1984).


327. See Note, supra note 322, at 1254 (all adhesion contract arbitration clauses should be held invalid (citing Sterk, Enforceability of Agreements to Arbitrate: An Examination of the Public Policy Defense, 2 CARDOZO L. REV. 481, 487 (1981))).


329. Id. at 1017-18. There may be an ability to negotiate some of the minor terms of the agreement, but the substance of the transaction is set and non-negotiable as far as the adhering party is concerned. Id. at 1018.

Many brokerage firms include the arbitration agreement as one of many clauses within an overall "Client's Agreement." "[T]he argument is made that a customer cannot maintain an account with a firm without executing such an agreement and therefore the agreement is an unenforceable contract of adhesion. Krebsbach & Friedman, Arbitral Forum, in Securities Arbitration Update 3, 19 (M. Fitterman & T. Krebsbach eds. 1989). Under the new disclosure requirements of the SROs, this concern may be ameliorated. See infra notes 708-24 and accompanying text.

The courts have interjected the defense of adhesion contract to protect the weaker party who is unable to protect himself. The issue presented in securities arbitration is whether there is another way to protect the consumer, especially the small investor, who lacks bargaining ability. Clearly, due to competition among brokers for its business, the larger, institutional investor has the bargaining power to omit predispute arbitration clauses from their brokerage agreements. The small investor, on the other hand, does not have this competitive advantage. In fact, many firms maintain that the small investor is not economical anyway. Consequently, in this oligopolistic industry, the small investor is clearly at a disadvantage in negotiating the terms under which he or she will find access to the securities markets—through the brokerage firms.

One commentator believes that "[i]n pre-dispute arbitration clauses . . . no true freedom of contract exists; securities customers must unilaterally waive a portion of their rights in order to be able to enter into a brokerage agreement [or transaction purchasing or selling almost any trading security]." Of course if the securities investor is permitted to opt out of arbitration, as is the case with many cash accounts, the question of adhesion is lessened. Several firms are already adopting the commodities trading optional language or otherwise highlighting this choice. In those bargaining situations where the parties are of unequal strength and one has taken advantage of the other in requiring consent of the "weaker" or "adhering" party to a particular clause in the stronger party's favor (i.e., a standardized written contract which is one-sided in requiring approval of particular terms such as arbitration or absence of warranties of merchantability or fitness for a particular purpose clauses and is imposed by the broker or seller on the consumer who does not have equal bargaining strength), the courts are reluctant to find adhesion clauses enforceable, particularly if it is also "unduly oppressive, unconscionable or [otherwise] against public policy." Consequently, the courts are an important ally of investor-customers in brokerage cases and may find the clause unenforceable. The rest of the

331. See supra note 63 and accompanying text.
333. See infra notes 834-35 and accompanying text.
334. See, e.g., David v. Merrill Lynch, Inc., 440 N.W.2d 269, 271-73 (N.D. 1989) (commodity claim of more than $15,000 not prohibited from arbitration despite claim that print was not "large" enough).
335. Sanchez, supra note 332, at 185-86.
agreement is nevertheless enforceable. The courts base this exception to freedom of contract on public policy grounds.

For example, in a recent Nevada case concerning a medical clinic's mandatory predispute arbitration agreement from patients, the Nevada Supreme Court found a contract of adhesion. There was no informed consent because when the patient signed the agreement she was informed that otherwise there would be no treatment given and there was no ability to modify any of its terms, including the waiver of right to trial. This same rationale can, of course, be applied to a case of a securities firm customer told that the only course is to agree to the customer agreement, without ability to modify its terms, and when he or she must accept arbitration and waive the right to litigate both securities and other claims which might arise.

But the small investor also has two other important allies: the SEC and consumer protection groups which might influence Congress, the SEC or the SROs. If the parties can use their forces to protect the small investor's interests, then freedom of contract notions should be applicable and judicial activism unnecessary. If the investor-consumer lacks the resources or ability to organize, however, the situation cries


This is so because to be unenforceable an adhesion contract must be unduly oppressive, unconscionable, or violative of public policy. Arbitration agreements cannot be cast in these terms since the Supreme Court has established a strong national policy favoring arbitration and has expressly approved SRO arbitral forums as fair and impartial. The courts have consistently held that arbitration agreements are not unconscionable as a matter of law. Thus, the argument that an arbitration agreement is void as an adhesion contract is uniformly rejected.

Id. (citations omitted).

337. See Note, supra note 95, at 1146-47. One need only remember the provisions of Uniform Commercial Code § 1-203 setting forth "[t]he principle . . . that in commercial transactions good faith is required in . . . performance and enforcement." U.C.C. § 1-203 official comment (1978) (emphasis added). Also relevant is § 2-302, allowing the courts to refuse to enforce a contract clause which is found to be unconscionable; this determination of unconscionability is one of law to prevent oppression and enforce a contract or clause which "is contrary to public policy or to the dominant purpose of the contract." U.C.C. § 2-302 official comment 1.

It is instructive to note that most brokerage firms will not permit a customer to open an account (particularly a margin, options or commodities account, although it is becoming more common even with cash accounts) without agreeing to mandatory arbitration provisions. Knight, Drive Targets Mandatory Arbitration, Washington Post, Sept. 22, 1988, at E1, col. 5.


out for adhering party protection: there is a defect in the contract's formation. Judicial or other intervention to correct this defect is required.  

Section 211 of the Restatement (Second) of Contracts, entitled "Standardized Agreements" provides that if the writing is reasonable and applies equally to all those similarly situated it will be valid, but "[w]here [a] party has reason to believe that the party manifesting . . . assent would not do so if he knew that the writing contained a particular term, the term is not part of the agreement." So if the language used is unreasonable, indecent or oppressive, unconscionable, the business is affected with a public interest, or the negotiations or transactions are tainted by economic duress, or superior bargaining power of one of the parties has been exercised to oppressive subjection of the other, the courts will override the terms of the agreement by finding a lack of assent to the adhesive terms. A Massachusetts court has held that "[c]ustomers who adhere to standardized contractual terms ordinarily 'understand that they are assenting to the terms not read or not understood, subject to such limitations as the law may impose.'"

In fashioning the rule of public policy on adhesion contracts, one commentator suggests that the court should consider "what the applicant might reasonably expect; [this is] just as relevant [as] the courts' own sense of what is fair." To date there has been no requirement

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341. Slawson, *Mass Contracts: Lawful Fraud in California*, 48 S. Cal. L. Rev. 1, 50 (1974). "It also comes close to speaking nonsense to argue that the kinds of legal changes herein suggested are beyond the proper constitutional authority of the judiciary. The legal doctrines concerning the determination of what is a contract and of contract damages were created by judiciaries." *Id.*

342. *Restatement (Second) of Contracts* § 211(3) (1979) (emphasis added).

343. The courts will look at the relationship of the parties and the customs and usages of the business to determine if the adhesive term is a "sound particularization of the deal" or "clauses of oppression or outrage." Rakoff, *supra* note 47, at 1202 (quoting K. Llewellyn, *The Common Law Tradition: Deciding Appeals* 366 (1960)).

344. See *U.C.C.* § 2-302 (Unconscionable Contract or Clause) and § 1-203 (Obligation of Good Faith) discussed *supra* note 337 and accompanying text; A. Corbin, *supra* note 325, § 559, at 270-71.

345. Where the nature of the business requires access to the industry by anyone, there is no discretion in the firms in the industry as to with whom they may deal under applicable regulation calling for nondiscrimination. Rakoff, *supra* note 47, at 1193 n.73.

346. *See id.* at 1193 n.74.


that the brokerage firm explain the terms and conditions of the customer agreement. It is really a question of what the "public has a right to expect," especially in contracts which deal with industries affecting the public interest, such as the securities markets. In a purely economic analysis, the securities markets have become price competitive only since the "Big Bang" of 1975, when the SEC and Congress required the abolition of fixed rates for commissions.

If the investor is forced to agree to a predispute arbitration agreement as a condition of access to the securities markets, freedom of contract is, of course, reduced. In reality, to enter the market the public investor is presented with "agreements resembling ultimatums or laws rather than mutually negotiated contracts" between contracting parties. Moreover, in many cases the stronger party will insert terms which are clearly overreaching.

Because arbitration clauses usually specify the arbitral forum as well, there are two other dimensions to the perception of overreaching by the party writing the contract. First, where the tribunals are industry-sponsored and there is a lack of common interest or shared commercial interests between the parties, such as between brokers and their customers, enforcement may be less desirable unless the panels are deemed fair by both sides.

Second, while seeming to permit a choice, there is, in reality, none because the industry is able to impose forum selection by virtue of limiting the choices of arbitration facilities available. The consumer is forced to choose between forums which are selected in the brokerage agreement. These forums are listed in the brokerage agreement be-


We know of no case holding that parties dealing at arm's length have a duty to explain to each other the terms of a written contract. We decline to impose such an obligation where the language of the contract clearly and explicitly provides for arbitration of disputes arising out of the contractual relationship.

Id.

351. The "Big Bang" refers to the SEC and industry regulations doing away with century-old industry-set commissions in favor of freely set charges competitively arrived at by the parties. See Gordon v. New York Stock Exch., Inc., 422 U.S. 659, 662, 673, 680, 682 (1975). The Court in Gordon, however, ultimately held that the actual fixing of commission rates by the SEC is immune to any attack under the antitrust laws. Id. at 685-86, 689.

352. See Katsoris, supra note 39, at 374. If a securities arbitration provision were like commodity accounts, there would be little problem: access to the public market cannot be so conditioned. See also Robbins, supra note 34, at 49.

353. Katsoris, supra note 39, at 374 n.83.

354. For example, one broker inserted a one-year statute of limitations in his customer agreement. Katsoris, supra note 39, at 375. (Despite Uniform Code of Arbitration § 4 six-year rule for bringing actions in arbitration).

355. Rakoff, supra note 47, at 1265.
cause they are convenient to the broker. This has been demonstrated where the brokerage firm seeks judicial stay of proceedings because of the arbitration clause calling for resolution in a forum distant from the broker. If the customer, whether plaintiff seeking redress for a wrongful execution or churning, or defendant being sued for a margin balance due, is required to arbitrate in a distant place, due process is frustrated. By permitting the securities investor to opt out of arbitration, as is the case with many broker's cash accounts, the question of adhesion becomes less. Accordingly, several firms are already adopting the commodities trading optional language or otherwise highlighting this choice.

2. Public Policy Defense

As previously stated, the contract of adhesion defense is a public policy defense and was raised in the Wilko, McMahon and Rodrigue de Quijas cases. It was one justification for SEC Rule 15c2-2. The Supreme Court recently weakened public policy defenses where it held that "refusal to enforce an award for contravention of public policy is only justified when such policy is well defined and dominant, as ascertained by reference to laws and legal precedents, rather than general considerations of supposed public interests."  

3. Unconscionability Defense

The concept of unconscionability is another judicially created doctrine permitting the avoidance of contracts which are harsh, oppressive, "shock the conscience" or "affront[] the sense of decency." While there is a distinction between procedural unconscionability, which is directed at defects in the bargaining process, and substantive unconscionability, which is directed at the content of a contract, the distinction is in enforcement: One which is procedurally unconscionable is normally enforceable if bargained for, but substantive unconscionability will make the contract unenforceable regardless of the

356. See Comment, supra note 111, at 404, 408-11, 416. See also infra note 527 and accompanying text.
357. See supra note 27 and accompanying text.
358. See David v. Merrill Lynch, Inc., 440 N.W.2d 269, 272-73 (N.D. 1989) (commodity claim of more than $15,000 not prohibited from arbitration despite claim that print was not "large" enough).

359. This is in accord with the newly adopted SIA Rules of Fair Practice concerning arbitration. See infra note 722 and accompanying text.
362. This may also include adhesive behavior.
bargaining context. Freedom of contract will permit procedures to be bargained away, but will not permit the enforcement of offensive agreements.\textsuperscript{363}

In a California case concerned with union arbitration in the entertainment field,\textsuperscript{364} the court denied enforcement on the grounds of unconscionability because there was a lack of "minimum levels of integrity"\textsuperscript{365} in the dispute resolution arrangement set forth in the contract, which was found to "smack[] of adhesion."\textsuperscript{366} This was an important extension of the role of unconscionability, because the court found that procedural grounds permitted a court to find the entire contract unenforceable as a matter of substantive law.\textsuperscript{367} Thus, the courts are to "police provisions and contracts for substantive abuses rather than encouraging them to search for procedural flaws on which to base their decisions."\textsuperscript{368} The adhesive nature of the procedural aspects of dispute resolution gave credence to the arguments of substantive unfairness under the adhesion theory, all of which permit the courts to take an active role in striking harsh terms to protect the weaker party.\textsuperscript{369}

But in Cohen v. Wedbush, Noble, Cooke, Inc.,\textsuperscript{370} the Ninth Circuit used McMahon to deny a customer's claim that the rules of arbitration were unconscionable since they were drafted by the securities industry. Holding that this argument, if upheld, would frustrate a "carefully crafted regulatory scheme,"\textsuperscript{371} the court found the arbitration agreement enforceable as a matter of law. According to the court, it did not matter that the customer had not read the contract before signing it. The court explained that "state law adhesion contract principles may not be invoked to bar arbitrability" under the Arbitration Act\textsuperscript{372} and there was no unfairness evident from a rule "expecting parties to read


\textsuperscript{365} Id. at 825, 623 P.2d at 176, 171 Cal. Rptr. at 615.

\textsuperscript{366} Id.

\textsuperscript{367} Note, supra note 328, at 1041.

\textsuperscript{368} Id.

\textsuperscript{369} Id. at 1046-47. The author suggests that this is "overly intrusive and opens the door to even more judicial interference with arbitration procedures than the Graham court may have intended. . . . [The] court opened the door to judicial tampering with freely negotiated but presumptively biased arbitration agreements." Id.

\textsuperscript{370} Cohen v. Wedbush, Noble, Cooke, Inc., 841 F.2d 282 (9th Cir. 1988).

\textsuperscript{371} Id. at 286.

\textsuperscript{372} Id.
contracts before they sign them."\textsuperscript{373}

In one case\textsuperscript{374} considering a one-year statute of limitations, the Sixth Circuit Court of Appeals found that there is nothing contrary to either state law or federal securities law (section 10(b) of the Exchange Act and Rule 10b-5) to the parties agreeing to a lesser statute of limitations. Further, since neither section 10(b) nor Rule 10b-5 provide a statute of limitations period, and because the three year provision of Exchange Act section 18(c)\textsuperscript{375} is not uniformly applicable to securities claims, the court looked to Michigan law. Michigan law allows private contracts limiting time in which a suit must be brought, although impliedly limiting the time to a reasonable period.

4. Fraud in the Inducement

Another means of looking at the underlying contract to determine the enforceability of the arbitration clause is through the argument that the contract itself came about due to fraud. In such a case the entire agreement is unenforceable for lack of a meeting of the minds at its inception.\textsuperscript{376} One commentator has referred to this as "induced mistake."\textsuperscript{377}

There are many cases treating execution of the customer agreement in securities accounts as having been compelled by fraud and undue influence. For example, a customer will argue that the broker "distracted his attention from the clause by treating the [entire] agreement's execution as a mere formality."\textsuperscript{378} Such a situation will prohibit arbitration until resolution of the issue of meaningful waiver is decided.\textsuperscript{379}

\textsuperscript{373} Id. at 287. In fact, this is in accord with common law. A person will be presumed to have intended the results of his agreement. His negligence in not reading the agreement he signed will not allow for his disaffirmance. See A. Corbin, supra note 323, § 607, at 656.


\textsuperscript{375} 15 U.S.C. § 78r(c) (1982). See also supra note 354.

\textsuperscript{376} See Annotation, Claim of Fraud in Inducement of Contract as Subject to Compulsory Arbitration Clause Contained in Contract, 11 A.L.R. 4th 774, 778 (1982); Restatement (Second) of Contracts § 163 (1979).

\textsuperscript{377} See Rakoff, supra note 47, at 1187.

\textsuperscript{378} Jeppsen v. Piper, Jaffray & Hopwood, Inc., Fed. Sec. L. Rep. (CCH) ¶ 93,995, at 90,650 (D.C. Utah 1988) (claims of fraud and undue influence); see also David v. Merrill Lynch, Inc., 440 N.W.2d 269 (N.D. 1989) (no fraud in inducement when a customer failed to allege that he was prevented from reading customer agreement; bold face type on options agreement stated that customer did not have to sign it to open commodities account). See also Miller v. Prudential Bach Sec., Inc., 884 F.2d 128, 132-33 (4th Cir. 1989); Curtis v. Newhard, Cook & Co., 725 F. Supp. 1072 (E.D. Mo. 1989).

\textsuperscript{379} Jeppsen, Fed. Sec. L. Rep. (CCH) ¶ 93,996, at 90,652.
In 1967, the Supreme Court in *Prima Paint*\(^ {380}\) considered the fraud in the inducement question in conjunction with the Arbitration Act. It was, however, limited to consideration of the arbitration clause alone. In *Mosley v. Electronic Facilities*,\(^ {381}\) the Supreme Court in 1963 held that an illegal contract results from fraud in the inducement. Therefore, while the Court in *Prima Paint* found that only the arbitration clause could be struck, the Court in *Mosley* struck the entire contract including the arbitration clause.\(^ {382}\)

But the fraud in the inducement must be separate from the conduct for which the customer is suing the firm.\(^ {383}\) For example, *Western Hospitals Federal Credit Union v. E.F. Hutton & Company*,\(^ {384}\) held that the broker, by churning the account, did not breach its fiduciary duty in a manner which would “bootstrap” fraud in the inducement as a separate reason for voiding the arbitration clause. Where there is fraud in the inducement and the clause is otherwise valid, there is authority for the courts to permit the arbitrator to determine the validity of the entire agreement or the arbitration clause itself.\(^ {385}\) The Montana Supreme Court reached a similar conclusion in *Larsen v. Opie*.\(^ {386}\) In *Larsen* the court held that allegations of fraud in the inducement by an unsophisticated investor who lost money in margin trading did “not dispute the validity” of the arbitration clauses specifically, but instead disputed the validity of the contracts generally. This resulted in the arbitrators having jurisdiction to determine the contract’s viability.\(^ {387}\) The real issue to be determined is whether there was a consensual acceptance of the arbitration clause and this can be decided in the arbitral forum just as well as in a court despite the difficulty in proving fraud in the inducement of only this particular clause in the customer’s agreement.

5. Waiver of Right to Arbitrate

In many cases, persons who do not want to have the dispute re-

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solved in arbitration will argue that the party seeking to compel arbitration has waived that contractual right, either through express waiver or, more usually, by action which would make it now inequitable to require the complaining party to submit to arbitration. A normal ground is that the parties have proceeded with the litigation. The courts will examine the facts carefully, but are bound to resolve any doubt in favor of arbitration.\textsuperscript{388} However, if prejudice to the other party is found, for example through participation in discovery, waiver is sometimes found.\textsuperscript{389}

\textsuperscript{388} See Nesslage v. York Sec., Inc., 823 F.2d 231, 234 (8th Cir. 1987) (citing Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24-25 (1983)) (defendants' participation in discovery and two-year delay in filing motion to compel arbitration did not constitute waiver of right to arbitration, in light of the retroactive application of Dean Witter Reynolds Inc. v. Byrd, 470 U.S. 213 (1985)). Accord Kronfeld v. Advest, Inc., 675 F. Supp. 1449, 1453 (S.D.N.Y. 1987) (some purchasers of Washington Public Power System bonds had signed arbitration clauses with the broker-underwriter from whom they purchased the bonds, but others had not; the court said "the prospect that different plaintiffs with like claims may have to litigate in two different fora is unpersuasive. . . . No cognizable prejudice . . . will result."); Rush v. Oppenheimer & Co., 779 F.2d 885, 887-89 (2d Cir. 1985) (defendants did not waive rights to arbitration even though they had delayed eight months before moving for arbitration, had moved to dismiss, filed an answer, and participated in discovery); MidAmerica Fed. Sav. and Loan v. Shearson/American Express Inc., 886 F.2d 1249 (10th Cir. 1989) (broker acted inconsistently with intent to arbitrate to mislead and prejudice of other party by, among other things, waiting to file motion to compel arbitration). See also Gilmore v. Shearson/American Express, Inc., 668 F. Supp. 314, 317 (S.D.N.Y. 1987), where claims previously determined to be non-arbitrable and a motion to compel arbitration, which was previously withdrawn at the request of a federal judge, were properly subject to a later motion to compel arbitration after the decision in Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987). Accord Brown v. Dean Witter Reynolds, Inc., 882 F.2d 481 (11th Cir. 1989). In Gilmore the court allowed the plaintiff the McMahon addition of the RICO claim stating:

[If before a case in a district court has proceeded to final judgment, a decision of the Supreme Court demonstrates that a ruling on which the judgment would depend was in error, no principal [sic] of "the law of the case" would want a failure on our part to correct the ruling.

The plaintiff has the burden of proving the prejudice which will justify waiver.\textsuperscript{390}

Some agreements may waive certain rights of a party. While this is permissible under freedom of contract notions, the waiver provision must not be unconscionable.\textsuperscript{391}

\textbf{a. Waiver in Securities Cases}

In the securities context, a continuing question is whether the broker has waived the contractual right to arbitrate. Several cases have considered the question of express or implied waiver of arbitration. The party seeking to establish waiver must demonstrate (1) knowledge of the right to compel arbitration; (2) acts inconsistent with that right; and (3) prejudice to the party opposing arbitration resulting from those acts,\textsuperscript{392} including substantial attorneys fees and costs incurred in pre-trial proceedings and in defending against the broker’s counterclaim and the passage of time. Participating in litigation for 6 months,\textsuperscript{393} 2 years\textsuperscript{394} or 2 1/2 years\textsuperscript{395} and failing to move to compel arbitration have been found to have prejudiced the investor because of use of judicial discovery not available in arbitration (at that time).\textsuperscript{396}

In \textit{Hurlbut v. Gantshar},\textsuperscript{397} the plaintiff claimed a waiver of arbitration by the broker’s failure for five months to move for a stay of proceedings pending arbitration. The court found that despite policies favoring arbitration, waiver can be express or implied,\textsuperscript{398} depending on the circumstances. An examination will normally look to (1) whether the party has actually participated in the lawsuit, such as filing a counterclaim, or taken other action inconsistent with his arbitration rights; (2) if the litigation machinery had been substantially invoked and was well

\textit{arbitrate} was found to have occurred. \textit{But see} Hurlbut v. Gantshar, 674 F. Supp. 385, 388-89 (D. Mass. 1987)(right to arbitration not waived where defendants waited five months after filing complaint to move for arbitration, but where defendants had asserted arbitration as an affirmative defense).


391. \textit{See} Hirshman, \textit{supra} note 29, at 1363 n.372 (discussing the unconscionable aspects of a waiver provision covering punitive damages).


398. \textit{Id.} at 388.
under way;\textsuperscript{399} (3) if the question of arbitration was brought up when the trial was near;\textsuperscript{400} or (4) if the other party was affected, misled or prejudiced by the delay in seeking a stay.\textsuperscript{401} The court concluded:

Unquestionably, the right to trial by jury is an important constitutional right, fundamental to the preservation of our system of individual rights and liberties. But the right, however significant, is not of such a nature that it cannot be knowingly and intelligently waived in favor of an arbitration process that places either party under an unreasonable burden or gives either party an unreasonable advantage.\textsuperscript{402}

The court found waiver, despite a presumption against waiver, where a firm waited six months prior to making a motion to compel arbitration. Here the firm brought the action in court, the customers were forced to answer the complaint, and the court held a scheduling conference. All this constitutes expense and prejudice as a result of the firm’s actions.\textsuperscript{403} Waiver of the right to arbitrate was appropriate.

But several cases have looked at the language in older customer contracts concerning the non-waiver required under now rescinded SEC Rule 15c2-2. As a consequence, it may be argued that if the customer’s claim is based on a securities law violation, arbitration can be avoided.\textsuperscript{404} The major argument in these cases is that the language of the rule is not mandatory but precatory—since most say the matters will be arbitrated except that it “may” (not “shall” or “will”) not apply to violations of the securities laws.\textsuperscript{405} Essentially, it is a question of con-

\textsuperscript{399} The \textit{Gantshar} court explained that “taking advantage of judicial discovery procedures not available in arbitration” was an example of substantially invoking the litigation machinery. \textit{Id.} (citing \textit{Jones Motor Co. v. Chauffeurs Local Union No. 633, 671 F.2d 38, 44 (1st Cir. 1989), cert. denied, 459 U.S. 943 (1982) (quoting Reid Burton Constr. v. Carpenters Dist. Council, 614 F.2d 698, 702 (10th Cir. 1980), cert. denied, 449 U.S. 824 (1980))).


\textsuperscript{401} \textit{Gantshar}, 674 F.Supp. at 388. In outlining these factors to determine justified waiver, the \textit{Gantshar} court cited \textit{Jones Motor}, 671 F.2d at 44 (quoting Reid Burton Constr., Inc. v. Carpenters Dist. Council, 614 F.2d 698, 702 (10th Cir. 1980)). The criteria were essentially established in \textit{Costantini v. TWA}, 681 F.2d 1199, 1201-02 (9th Cir. 1982), cert. denied, 459 U.S. 1087 (1982) which was concerned with the \textit{res judicata} effect of an arbitration and concluded that the most important of several criteria outlined was “whether the two suits arise out of the same transactional nucleus of facts.” \textit{Id.} at 1202.


\textsuperscript{403} See supra note 398.


\textsuperscript{405} This is the Rule 15c2-2 requirement. Several cases have interpreted the language “this agreement . . . does not apply to any controversy . . . for which a remedy may exist [pursuant to the federal securities laws]” to mean there was no agreement to arbitrate contested issues even though it has been later determined
tract interpretation.\textsuperscript{406} With the requirement that every ambiguity is to be resolved in favor of arbitration, courts have consistently held, despite the fact the clause is perhaps unclear, that arbitration is also contemplated for securities law claims.\textsuperscript{407} To find otherwise would again present the bifurcated presentment of the same issues in different forums: a poor result.\textsuperscript{408}

If, however, the controversy’s facts arose prior to the time that the investor signed the arbitration agreements, at least one court has held that arbitration should be denied.\textsuperscript{409}

In one case,\textsuperscript{410} an investor claimed, \textit{inter alia}, waiver of the right to

that such remedies are available in arbitration. Van Ness Townhouses v. Mar Indus. Corp., 862 F.2d 754 (9th Cir. 1988), held that such language indicated quite clearly the intent of the parties to exclude such claims from arbitration. \textit{Id.} at 757. Therefore, the policy favoring arbitration when there is an ambiguity is inapplicable. Kadow v. A. G. Edwards and Sons, Inc., Fed. Sec. L. Rep. (CCH) ¶ 94,822 (W.D. Ark. 1989) (parties bound by plain language of agreements); Stander v. Financial Clearing & Services Corp., 718 F. Supp. 1204, 1209 (S.D.N.Y. 1989) (“contract unambiguously creates a substantive securities claim exception to the agreement to arbitrate . . .”). \textit{See infra} note 412 and accompanying text.


\textit{But see} A.G. Edwards & Sons, Inc. v. Smith, 715 F. Supp. 288 (D. Ariz. 1989) (“Had the parties intended arbitration of securities claims certainly more clear language could have been employed. As a result, the court concludes that the federal securities claims against defendants are not subject to arbitration and will remain within the purview of the present lawsuit.”); Haver v. B.C. Christopher Securities Co., 21 Sec. Reg. & L. Rep. (BNA) 594 (Apr. 21, 1989) (D. Kan. 1989) (SEC rescission of Rule 15c2-2 “should not be interpreted as an exception to the arbitration agreement”); Gooding v. Shearson Lehman Brothers, Inc., 878 F.2d 281, 284 (9th Cir. 1989) (“any ambiguity . . . should be resolved against [the brokerage], since they drafted the agreement”); Amadio v. Blinder Robinson & Co., 715 F. Supp. 32 (D. Conn. 1989) (nowhere was this exclusion linked to the continued existence of the SEC regulation); Ballay v. Legg Mason Wood Walker Inc., 878 F.2d 729 (3d Cir. 1989).


arbitrate when his broker sent out, in response to his request for a copy, the "old" form with the non-arbitration language instead of the form reflecting the repeal and McMahon, which the investor had actually signed. This was found to not constitute substantial prejudice or waiver. Most cases, however, are concerned with the retroactive application of the repeal and McMahon; and most find in favor of arbitration.\textsuperscript{411}

In response to this situation, several firms sent new agreements to customers, asking them to sign and return the "new" agreement telling them that the process is to "update" records and not disclosing this substantial change. This is a deceptive practice which should be stopped.\textsuperscript{412}

In Cadavel \textit{v.} Dean Witter Reynolds, Inc.,\textsuperscript{413} arbitration was required under the McMahon preference, despite a clause in the customer agreement that the customer's "agreement to arbitrate does not constitute a waiver of the right to seek to resolve claims arising under federal securities laws in a judicial forum . . . ,"\textsuperscript{414} because the second part of the clause indicated that the anti-waiver provision would only apply when the waiver was void under the securities laws.

Several cases have considered whether the waiver of the right to litigate by investors in brokerage contracts is a question of knowing waiver. For example, in Stander \textit{v.} Financial Clearing \& Services Corp.,\textsuperscript{415} in which an elderly widow with little stock market experience had her entire account wiped out and owed substantial sums to the brokerage firm as a result of the October 1987 crash, the Second Circuit found the predispute arbitration clauses inoperative under the old customer agreement language that all claims could be arbitrated except those arising under federal securities laws. "The issue here is one of contract interpretation; did the parties reach a substantive agreement that securities law claims could not be arbitrated? Or did they agree to arbitrate their claims to the full extent allowed by the law, and merely include a mandated notice provision . . . ?"\textsuperscript{416}

The court concluded that the "understanding" of the contract clause was crucial. It looked to former SEC Rule 15c2-2\textsuperscript{417} and found


\textsuperscript{414} \textit{Id.}


\textsuperscript{416} \textit{Id.} at 1207.

\textsuperscript{417} \textit{See supra} note 173 and infra note 739 and accompanying text.
that its principles should control despite McMahon. The conclusion forbade waiver of the right to litigate if the language of the contract did not "evoke mere notice or non-waiver."\textsuperscript{418}

In several other cases the plaintiffs' arguments that the old Rule 15c2-2 language purporting not to waive litigation for federal securities claims were found to be without merit.\textsuperscript{419}

6. Other Contract Defenses

As with the defenses of adhesion, unconscionability, and fraud in the inducement, other typical contractual defenses can be raised against the enforceability of the entire broker-investor agreement, which may also contain an arbitration clause. These would include incapacity defenses, such as minority, mental infirmity, and disability, breach of fiduciary duty,\textsuperscript{420} self-dealing, duress, undue influence, misrepresentation, non-disclosure, and mistake.

Forgery, or absence of a genuine signature, is also a common defense against the enforcement of the entire agreement, including the arbitration clause.\textsuperscript{421} In order to plead forgery as a grounds to avoid arbitration, the parties must establish why the court should not permit the arbitrator to decide this issue. A good way of doing this would be to file an affidavit of a handwriting expert alleging the signatures are forgeries. Absent such a meeting of the burden of proof, the court must assume the arbitration agreement is valid.\textsuperscript{422}

\textsuperscript{418} Stander, 718 F. Supp. at 1207.
\textsuperscript{419} Paulson v. Dean Witter Reynolds Inc., 708 F. Supp. 1163, 1166-67 (D. Or. 1989) (citing Van Ness Townhouses v. Mar Indus. Corp., 862 F.2d 754 (9th Cir. 1989) and Wehe v. Montgomery, 711 F. Supp. 1035 (D. Or. 1989)). The Paulson court found that "any provision executed while Rule 15c2-2 was in effect and which purports to bind a customer to arbitration of federal securities claims is unenforceable." Id. at 1167. \textit{See also supra} note 405.
\textsuperscript{420} \textit{See} Krause, \textit{supra} note 382, at 701. "[B]reach of fiduciary duty may also render the arbitration agreements unenforceable." \textit{Id.} (citations omitted).
\textsuperscript{421} The issue of validity of the entire agreement is affected by forgery. Donato v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 663 F. Supp. 669 (N.D. Ill. 1987); Gilmore v. Shearson/American Express, Inc., 668 F. Supp. 314, 320 (S.D.N.Y. 1987) (plaintiff having no recollection of seeing customer's agreement, let alone signing it, but making no contention signature was obtained by forgery or fraud, cannot avoid the rule that a person of ordinary understanding and competence will be bound by contract provisions whether or not he has read them); Hall v. Shearson Lehman Hutton, Inc., 708 F.Supp. 711, 712 (D. Md. 1989) (claim of forgery supported by an affidavit and documents examiner, however, questions as to authority of another to sign for him were to be resolved by arbitrator); Shirl v. Drexel Burnham Lambert, Inc., Fed. Sec. L. Rep. (CCH) ¶ 94,467 (D. Minn. 1989) (parties conduct, including receipt of confirmation slips containing arbitration provisions, established the existence of contract to arbitrate disputes in margin account; the arbitration acceptance was the only way broker would accept customer margin accounts). \textit{See also} Krebsbach & Friedman, \textit{supra} note 329, at 21-22.
In securities cases a customer often will maintain that he or she never saw, let alone signed, the customer agreement containing the arbitration clause. Often the customer will contend he or she did not read the contract. This will not constitute a good defense here any more than in any other contract case.\textsuperscript{423} Clearly, the parties do not have to explain the contract under present law.\textsuperscript{424}

It is, of course, beyond the scope of this article to review the law in these areas. But this article does examine the defenses of particular use in securities litigation. The issue is one of enforceability: Can the contract stand despite the defense? If so, the next inquiry is to the arbitration clause: Can it be enforced?

7. Result

An agreement to arbitrate was permitted at common law. Usually, it was found as a condition precedent to the right of a party to bring suit,\textsuperscript{425} but the general rule remains that either party may revoke a submission to arbitration under contract at any time before an award has been made. Such party will be liable, however, for damages for breach of contract.\textsuperscript{426} Under common law arbitration, then, an arbitration award was enforceable only if (1) the parties had agreed to submission; (2) the submission and award were within the scope of the agreement; and (3) all of the submission was decided.\textsuperscript{427}

B. \textit{Statutory Arbitration}

As noted above, due to the reluctance of the courts to enforce prediscussion agreement clauses between parties to a contract and


425. R. Rodman, supra note 305, at 47-51 (citing cases holding that whereas the courts would not oust themselves of jurisdiction, nevertheless arbitration could be compelled as a condition to later bringing a judicial action. It is as though a party has failed to observe a statutory procedure.).


427. See \textit{id.} at 48 (citations omitted).
the limitations on validity of common law arbitrations, various statutes have been enacted by the states and federal government providing for enforceability of arbitration agreements. In those situations where the statute does not specify procedures, common law arbitration rules will still apply and revocability will be permitted.

The major thrust of such statutes is, however, that an agreement to arbitrate an existing dispute is not revocable at any time prior to the award, as was the case at common law. The party against whom the other seeks judicial review is not under the typical statute relegated only to damages for breach of the agreement to arbitrate; if a party refuses to appoint an arbitrator, the appointment may be made by the court; if a party institutes a judicial action, an order may be entered staying its prosecution; an order may be entered compelling a defaulting party to perform the arbitration agreement; and, perhaps most importantly, these statutes provide that an award can be enforced through judicial means, typically an execution on a judgment entered on the basis of the arbitration award. The statutes also provide, somewhat, for arbitration procedure—issuance of subpoenas, discovery, including taking of depositions, administration of oaths, and the like.

Between 1980 and 1984 more than 17 states have enacted arbitration and mediation laws. This explosion in legislation is also reflected in the development of private firms specializing in alternative dispute resolution. There is support from business, lawyers and the community at large for such programs in diverse areas including family law and divorce, automobile "Lemon Laws," voting rights and many other areas. Mediation and arbitration are being used in all sorts of fields, for all manner of disputes. The statutes "break down institu-

428. See infra text accompanying note 442, indicating that several states do not have arbitration statutes even today.
429. In fact, not every state statute subscribes to the same liberal principles as the Arbitration Act. See Fletcher, supra note 29, at 398-400.
430. England, for example, passed its first arbitration act in 1698, but that act allowed for revocation of submission. By the turn of the century English law had been revised so that predispute arbitration agreements were enforceable. See Sayre, supra note 99, at 605-07.
432. R. Rodman, supra note 305, at 52.
433. Id. § 7(a) Subpoenas, § 7(b) Initiation of Proceedings, and § 26 Administration of Oaths.
434. Freedman, Legislation on Dispute Resolution, 1984 A.B.A. Special Committee on Dispute Resolution i.
435. See infra text accompanying note 559.
436. Freedman, supra note 434, at i, ii.
tional barriers to mediation by establishing methods for courts and other entities to refer cases. They also provide guidelines for mediators on important ethical and legal issues." 437 Many have received governmental funding, in addition to credibility from this legislative support, due to the perceived "public" function of this type of dispute resolution. 438

Under most arbitration statutes there is still judicial review. As noted above, those statutes invoking voluntary arbitration between the parties still permit a court to review the formation of the contract to be sure that it is an enforceable one. Any contract defense may be used to show the lack of requisite agreement to arbitrate. 439 Most statutes also provide for the right of the court to review the award, as well as to modify, correct or confirm it as so corrected. 440 The usual reasons for modification or correction are manifest disregard of the law or facts presented, public policy or other abuse of the process of arbitration. There are few laws which require mandatory arbitration of disputes. 441

1. Uniform Arbitration Act

"The Uniform Arbitration Act was approved by the National Conference of Commissioners on Uniform State Laws and the American Bar Association in 1955." 442 The Act, like the Federal Arbitration Act, first validates arbitration agreements and finds them "valid, enforceable and irrevocable, save upon such grounds as exist at law or in equity for the revocation of any contract . . . ." 443 It then sets forth the proce-

437. Id. at ii.
438. Id.
439. See supra note 320 and accompanying text.
440. See R. Rodman, supra note 305, § 3.2, at 52.
442. See R. Rodman, supra note 305, § 3.4, at 55. The 1955 Uniform Arbitration Act is similar to the Federal Arbitration Act of 1925. See Note, supra note 94, at 1141. It has been amended since 1955. It succeeded the prior 1925 Uniform Act, which was withdrawn by the Commissioners in 1943. Rodman notes that the Uniform Act follows the arbitration laws of New York and some fifteen other states. R. Rodman, supra note 305, § 3.4, at 56. The 1955 Act was adopted in 1960 in Massachusetts. MASS. GEN. LAWS ANN. ch. 251, §§ 1-19 (West 1988).

The only states which do not have arbitration statutes allowing for future dispute clauses are Alabama and West Virginia. Georgia has a modern law solely for construction disputes. R. Rodman, supra note 305, § 3.7, at 64.
443. Uniform Arbitration Act § 1 [hereinafter Uniform Act].
dures to compel or stay arbitration, provides for court appointment of arbitrators in the absence or with a failure of the agreement to so provide, provides for the hearing, witnesses, subpoenas, depositions, fees and expenses, provides for exercise of power by a majority of arbitrators, and has several provisions regarding the award and its modification and correction, including judicial review and enforcement. Forty-five states have adopted some variation of the modern arbitration law embodied in the Uniform Arbitration Act.

2. Recent State Arbitration Enactments

Businesses are resorting more and more to arbitration as an alternative to litigation in resolving civil disputes. New Jersey has enacted an entirely new arbitration statute, adopted in response to the complaints about the Uniform Act’s arbitration procedures. This statute provides for discovery, including exchange of documents and depositions; appeal of various procedural issues; requirements that the award be in writing and state findings of fact and conclusions of law used by the arbitrators; and provides that arbitration is fully reviewable by a court if there is legal error.

3. United States Arbitration Act

Congress passed the Arbitration Act in 1925. This was done as an exercise of the commerce power. It creates a substantive federal right. Both the Arbitration Act and the Uniform Arbitration Act

444. Id. § 2.
445. Id. § 3.
446. Id. § 5.
447. Id. § 7.
448. Id. § 10.
449. Id. § 4.
450. See id. §§ 8-9, 11-14, 16-19.
451. All fifty states, the District of Columbia, and Puerto Rico have enacted arbitration statutes. For a citation listing these statutes see Robbins, supra note 34, at 193-94.
452. Brown, Shell & Tyson, Arbitration of Customer-Broker Disputes Arising Under the Federal Securities Laws and RICO, 15 SEC. REG. L.J. 3 (1987). Arbitration cases in commodities and securities disputes were overtaking those filed in federal courts. Id. at 33, n.92. See also supra text accompanying note 138.
454. See Shell, supra note 102, at 431 (citing the various sections of the New Jersey statute). A similar arbitration bill was introduced in the 100th Congress.
were derived from the earlier New York law. 457

While the two statutes are similar, there are some differences. 458 The Federal statute will apply in matters of interstate or foreign commerce 459 and applies in both federal and state courts. 460 One of the major differences is the power of the federal courts to remove from state courts. 461

4. Result Favors Arbitration

The statutes, both federal and state, encourage arbitration of disputes and permit the enforceability of predispute agreements. The courts have consistently found legislative approval, and perhaps even encouragement, of parties submitting disputes to a non-judicial forum. While the arguments are that such process is less expensive and quicker than judicial action, 462 one major advantage is that an increasing number of cases are being referred to arbitration with the result that the court system, despite modernization and larger numbers of judges and courtrooms, is relieved of an even larger caseload. 463

C. Appeal of Court Orders on Arbitrability

Under section 3 of the Arbitration Act, an appeal is immediate for denial of certain arbitrability orders. 464 So a stay pending arbitration will permit appellate review. But a denial of arbitration is probably immediately appealable because orders that grant or deny injunctions, and orders that have the practical effect of granting or denying injunctions, have “serious, perhaps irreparable, consequences. . . .” 465 Therefore, the denial of arbitration will be appealable at once. This is true regardless of the fact that final judgment will be appealable under the Supreme Court’s finality rule. 466

457. R. Rodman, supra note 305, at 68. See supra note 128-50 and accompanying text.


460. See R. Rodman, supra note 305, at 69 nn.16-17.


462. See R. Rodman, supra note 305, at 6-10; supra notes 43-84 and accompanying text.

463. See supra notes 27-46 and accompanying text.


466. See McDonnell Douglas Finance Corp. v. Penna. Pwr. & Light Co., 849 F.2d
On November 19, 1988 a new section was added to the Arbitration Act providing that an appeal may not be taken from an interlocutory order "(1) granting a stay of any action under Section 3 . . .; (2) directing arbitration to proceed under Section 4 . . .; (3) compelling arbitration under Section 206 of [the Arbitration Act]; or (4) refusing to enjoin an arbitration that is subject to this title." 467 As a result, a number of securities cases have found orders to compel arbitration unreviewable, even retroactively. 468 This law reversed the Enelow-Etelson doctrine, which made the grant or denial of a stay of an action at law pending arbitration automatically appealable under 28 U.S.C. section 1292(a)(1). 469

D. Finality of Arbitration

The decision in arbitration could have res judicata effect, even where federal issues are involved. 470 There are few grounds, under the typical arbitration statute, for a court to disregard the decisions of the arbitration forum. These are usually fraud, misconduct, denial of due process, including manifest disregard of the law 471 or facts, and that the

468. See Campbell v. Dominick & Dominick, Inc., 872 F.2d 358 (11th Cir. 1989) (Act meant to apply to appeals in cases pending on date of its enactment); Jeske v. Brooks, 875 F.2d 71 (4th Cir. 1989); C.B.S. Employees Fed. Credit Union v. Donaldson, Lufkin & Jenrette Sec. Corp., Fed. Sec. L. Rep. (CCH) ¶ 94,385 (W.D. Tenn. 1989) (fraud went to the very nature of the contract, so it was for the court, not the arbitrator, to determine); Rauscher Pierce Refsnies, Inc. v. Birenbaum, 860 F.2d 169 (5th Cir. 1988) (denial of stay pending arbitration not appealable under collateral order doctrine because judgment could be set aside with claims referred to arbitration and no serious or potentially irreparable consequences); Turboff v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 867 F.2d 1518 (5th Cir. 1989); Purdy v. Monex Intern., Ltd., 867 F.2d 1521 (5th Cir. 1989). But see Delmay v. Paine Webber, 872 F.2d 356 (11th Cir. 1989) (retrospective application conferring appellate jurisdiction applies to pending cases); McGowan v. Sears, Roebuck and Co., 722 F. Supp. 1069, 1076 (S.D.N.Y. 1989) (claims under state law involved different elements so that outcome of one proceeding not determinative of the other; whether to stay arbitration "is a decision left to the district court as a matter of its discretion to control its docket") (citation omitted).
469. See Thompson McKinnon Sec., Inc. v. Salter, 873 F.2d 1397 (11th Cir. 1989) (order final and appealable as it resolves only issue before District Court). See also Rauscher, 860 F.2d at 170-71.
471. In Wilko, the Supreme Court indicated "a failure of the arbitrators to decide in accordance with the provisions of the Securities Act would constitute grounds for vacating the award pursuant to [the Arbitration Act]." Wilko v. Swan, 346 U.S. 427, 436 (1953) (citation omitted). Justice Frankfurter commented that all the
arbitrators have exceeded their powers, or failed to render a final and definite award which the courts can be called upon to enforce. In these instances, the court will review the process itself.\textsuperscript{472} One commentator notes:

Sections 10 and 11 of the \dots Arbitration Act enumerate the following grounds for vacating or modifying an award:

1. Procurement of the award through fraud, corruption, or undue means;
2. Partiality of the arbitrators;
3. Misconduct of the arbitrators including the refusal to hear evidence or postpone the hearing upon sufficient cause shown;
4. The arbitrators exceeded their powers;
5. The award was made upon a matter not submitted to arbitration; and
6. The award was arrived at through a material miscalculation or other mistake.\textsuperscript{479}

It is well established that errors of law or fact will not permit setting aside an award.\textsuperscript{474} "Once an arbitration award is entered, the finality that courts should afford the arbitration process weighs heavily in favor

Justices agreed that "[a]rbitrators may not disregard the law." \emph{Id.} at 440 (Frankfurter, J., dissenting).

The same point was reached by the Court in \emph{McMahon}. Justice O'Connor indicated that the possibility of judicial review under the securities laws "is sufficient to ensure that arbitrators comply with the requirements of the [Arbitration Act]" and not disregard the law. \emph{Shearson/American Exp.}, Inc. v. \emph{McMahon}, 482 U.S. 220, 232 (1987) (citation omitted).


In \emph{Tinaway v. Merrill Lynch & Co.}, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) \# 93,218 (S.D.N.Y. 1987) the court was "unable to infer a ground for the arbitrators' decision from the facts of [the] case" and vacated the award on the basis of the "evident partiality" of the arbitrators.

As the court stated in \emph{Davis v. Chevy Chase Fin. Ltd.}, 667 F.2d 160 (D.C. Cir. 1981) with respect to the scope of the arbitrators' powers:

In sum, the genesis of arbitral authority is the contract, and arbitrators are permitted to decide only the issues that lie within the contractual mandate. By necessary implication, an arbitral award regarding a matter not within the scope of the governing arbitration clause is one made in excess of authority, and a court is precluded from giving effect to such an award. \emph{Id.} at 165 (citations omitted).

\textsuperscript{474} Miller v. Prudential Bache Sec., Inc., Fed. Sec. L. Rep. (CCH) \# 94,560 (4th Cir. 1989). \textit{See also} Hoellering, \emph{supra} note 359, at 32.
of the award, and courts must exercise great caution when asked to set aside an award." 475 Therefore, absent exclusion of pertinent and material evidence, the award normally will not be subject to review because the arbitrator failed to consider particular arguments, especially if the parties themselves participated in the arbitration and could have, or should have, brought all relevant facts to the attention of the arbitrator. The standard of manifest disregard is a high one: It does not include the arbitrator’s decision when presented with conflicting facts or legal theories, but applies when there is little likelihood that a reasonable person would have decided the way the arbitrator did, given the law or facts presented. There can be no appeal on the merits of the arbitrator’s decision, only on the basis of the process. 476

There are strict time limits on vacatur of awards under the applicable law. For example, under the Arbitration Act a litigant has three months from the time an award is filed or delivered to serve notice of motion to vacate on the adverse party, or his or her attorney. 477 There is a slight anomaly here, however, since the parties have one year to bring an action to confirm an award, and the right to defend a motion to confirm after the three month period for vacatur will preclude raising vacatur after that period. 478

Although arbitrators “may properly render a lump sum award without disclosing their rationale . . . [,] where the award has no factual support the Court may properly vacate.” 479

There is no right to appeal a decision of arbitrators which does not give an explanation for even a seemingly erroneous award. In Sargent v. Paine, Webber, Jackson & Curtis, Inc. 480 a claim for $256,000 in compensatory damages and $500,000 in punitive damages resulted in an award of $46,000 for the investor, without any reasons given as to how this

475. Foster v. Turley, 808 F.2d 38, 42 (10th Cir. 1986) (citations omitted).
476. Id. at 42-43.
sum was reached. The District of Columbia Circuit Court found that the Arbitration Act did not require, as an effective element of judicial review, a demand to obtain an explanation. To require explanations would defeat the interests of “swift and thrifty” dispute resolution sought to be obtained by the Arbitration Act. The interest of possibly rooting out error would not take precedence. The plaintiffs were required to establish facts showing that there was probable error, justifying vacatur of the award. They failed to do so. Error permitting vacatur of an award must, therefore, be almost patent. Otherwise, there is a deference to the decision-making as being properly discharged on grounds of public policy. In short, the court concluded that “insistence on an explanation of the decision-maker’s thought process” is not an automatic requirement for “effective judicial review.”

As a result of the holding in McMahon, that section 10(b) and RICO claims are both arbitrable, and the Rodriguez de Quijas determination that section 12(2) claims are also arbitrable, “almost all” customer/brokerage securities lawsuits will be submitted to arbitration, including securities fraud actions. There is no question but that the result of these cases will be to tremendously increase the arbitration caseloads of the SROs and the AAA. Two procedural problems, however, have been created by the Supreme Court’s bifurcation of similar factual issues, to both arbitration and litigation, depending on what type of claim has been asserted. Remember, a case can be divided into those claim elements which are arbitrable and those to which the claimant is entitled to litigate. One problem is the question of the collateral estoppel effect that awards should be given in later or simultaneous litigation. Another problem is the question of the proper order of the

481. Id. The court noted that there were reasons why the arbitrators might have concluded that the plaintiff should not recover the large sums he sought. Although he was a “first time investor,” the court found him sophisticated and that he knew the risks and directed the trades and failed to complain for five months about the trades complained of. This also might have supported a finding that no punitive damages were appropriate.

482. See Galt v. Libbey-Owens-Ford Glass Co., 397 F.2d 439 (7th Cir. 1968) (remand to determine if arbitrators considered a specific contract clause as within purview of arbitration provision); Sobel v. Hertz, Warner & Co., 469 F.2d 1211 (2d Cir. 1972) (distinguishing cases regarding remand to clarify what issues arbitrators resolved).

483. Sargent, Fed. Sec. L. Rep. (CCH) ¶ 94,566 (citing Women Involved in Farm Econ. v. Department of Agriculture, 876 F.2d 994, 998-1000 (D.C. Cir. 1989) (appeal of administrative agency decision)).


485. AAA caseloads will increase provided the dispute arbitration agreement provides for AAA arbitration. Most brokerage account agreements, however, allow the customer to select among SRO forums, typically either NYSE, American Stock Exchange or NASD. See infra note 518 and accompanying text.

486. See supra note 202 and accompanying text.
two sets of dispute resolution—should one take place first, or both together?

1. Order of Dispute Resolution

Upon application of one of the parties, the courts will consider the question of prioritizing litigation or arbitration. This ordering of the proceedings is important in several respects. First, the preference for the Arbitration Act requires an automatic bifurcation, making possible disposition of arbitrable and non-arbitrable claims, separately and simultaneously, with the possibility of greater delay and inefficiency.\(^{487}\)

With arbitration and litigation simultaneously proceeding, or one stayed pending determination of the other, confusion may well reign. In addition, such bifurcated proceedings are perhaps to the great disadvantage of the one the securities laws and public policy should be protecting—the customer/consumer. Since many customers seeking redress will be doing so because of financial chaos and possible bankruptcy,\(^{488}\) it seems dual proceedings can have a very unfair result.

2. Collateral Estoppel

The Supreme Court has not ruled on the collateral estoppel effect of arbitration awards.\(^{489}\) Based on the principle that relitigation is unfair and a waste of resources, the common law doctrine of collateral estoppel prohibits duplicate resolution of the same issue in a subsequent proceeding.\(^{490}\) Three requirements must be met by the party seeking to apply collateral estoppel:\(^{491}\) (1) the issue must be identical to one already litigated; (2) the same parties must have litigated it in another proceeding;\(^{492}\) and (3) the determination of the issue must

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\(^{487}\) See Ginger, supra note 29, at 536-37 (citing Katsoris, The Securities Arbitrators’ Nightmare, 14 FORDHAM URB. L.J. 3, 8 & n.30 (1986)).

Because disputes between investors and brokers arise frequently but often involve modest sums, a uniform and efficient alternative . . . is desirable. Instead of handling the problem of resolving these disputes by ordering immediate arbitration and staying litigation of the nonarbitrable claims until after the arbitration concludes, perhaps all securities-related claims should be consolidated in an arbitration proceeding in the first place.

\(^{488}\) In many cases the broker is suing the customer for the balance due, as a result of a margin call, after the customer’s account has been sold out; or the customer is suing a broker for churning or other misconduct, but with little or no assets left. See Comment, supra note 111, at 410.

\(^{489}\) Katsoris, The Securities Arbitrators’ Nightmare, 14 FORDHAM URB. L.J. 3 (1986); Ginger, supra note 29, at 537 & n.147 (citing Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213 (1985)). See also Krebsbach & Friedman, supra note 30, at 577-78.

\(^{490}\) Ginger, supra note 29, at 538 (citations omitted).

\(^{491}\) See RESTATEMENT (SECOND) OF JUDGMENTS § 27 comment d (1980).

\(^{492}\) Occasionally a third party, who was not party to the prior litigation, will invoke collateral estoppel to preclude relitigation of an issue completely resolved even as to him by the prior proceeding. This result is possible because the prior
have been essential to the decision in the earlier proceeding.493 New York adds a requirement that must be applied by both state and federal courts construing New York law:494 that there was a "full and fair opportunity" to present the issue in the prior case.495 The result is finality of arbitration,496 with the concomitant judgment requiring the parties to act in accordance with the decision rendered.497

In ordering arbitration to take place despite the risk of preclusion, the [Byrd] Court apparently agreed with those courts that had taken the position that the threat of collateral estoppel "does not justify denying arbitration of otherwise arbitrable intertwined state law claims." In his concurrence, Justice White made this point explicitly, stating that fears of collateral estoppel should not cause a district court to stay or refuse to compel the arbitration of arbitrable claims.498

In order for collateral estoppel to apply, the subsequent trier must be made aware of the determination of the issues presented. In present arbitration practice this is virtually impossible because arbitrators only give the "bottom line" result. While in single-issue disputes this will not create a problem, it may in the case of multiple inconsistent claims on the same facts. The problem arises because of the intertwining nature of the facts and law in securities cases, now including RICO claims. It may be more difficult to give the arbitrator's determination collateral estoppel effect: it is not clear on which claim's determination the "bottom-line" remedy was decided. One commentator suggests that this problem can easily be solved by requiring the arbitrator to make "separate and specific findings of fact as to each factual issue presented . . . ."499 This is the result of the newly adopted SRO

493. See Fletcher, supra note 29, at 432; Ginger, supra note 29, at 538.
494. The significance of governing law provisions of brokerage contracts is thus controlling. See supra notes 86-101, 135 and accompanying text.
496. The litigation aspect of the collateral estoppel doctrine has raised the question whether it should be applied in arbitrations. Efficiency and economy will result from such an application of the doctrine, but the question has seldom been addressed. See Ginger, supra note 29, at 539 (citing Mobilia, Offensive Use of Collateral Estoppel Arising Out of Non-Judicial Proceedings, 50 ALB. L. REV. 305, 321 (1986)).
497. Ginger, supra note 29, at 539. In some jurisdictions the award must have been entered as a judgment. E.g., Ulheil Constr. Co. v. Town of New Windsor, 478 F. Supp. 766 (S.D.N.Y. 1979). But this is not always the case. See City of Gainesville v. Island Creek Coal Sales Co., 618 F. Supp. 513 (N.D. Fla. 1985) (collateral estoppel applied to issue of damage award without requiring entry of judgment).
498. Ginger, supra note 29, at 541 (citations omitted). See also Krebsbach & Friedman, supra note 30, at 577-81.
499. Ginger, supra note 29, at 544. See infra note 681 and accompanying text.
procedures.\textsuperscript{500}

Collateral estoppel is a decision within the judge’s discretion. As long as the right of the parties to full and fair review is protected, collateral estoppel can result from arbitration. Factual findings are particularly within the authority and expertise of a securities panel.\textsuperscript{501} The Eleventh Circuit stated that:

\begin{quote}
[A] federal court should be hesitant to preclude the litigation of the federal claim based on the collateral estoppel effects of a prior arbitration award. These cases indicate a case-by-case approach . . . focusing on the federal interests in insuring a federal court determination of the federal claim, the expertise of the arbitrator and his scope of authority under the arbitration agreement, and the procedural adequacy of the arbitration proceeding.\textsuperscript{502}
\end{quote}

"[A]lthough arbitrators may properly render a lump sum award without disclosing their rationale . . . where the award has no factual support the Court may properly vacate the award."\textsuperscript{503} In a recent case, \textit{Tinaway v. Merrill Lynch and Co., Inc., et al.},\textsuperscript{504} the arbitrators had given an award of only five percent of the amount an investor "allegedly lost due to the claimed wrongdoing of the brokerage defendants." The court found that there was no manifest disregard of the law nor were the arbitrators found partial to the defendants. The plaintiff had been unable to show any evidence of direct pecuniary, business or personal relationship, and although the "small size of the award may suggest that the arbitrators were influenced by their general professional interests," this was a "general" versus reversible bias. There was no showing of direct, demonstrable bias and "remote, uncertain or speculative bias" is not sufficient.\textsuperscript{505} Further, the court felt that to give reasons for an award, while it "would help to uncover egregious failures to apply the law" in such a manner that the award could be reversed, "would undermine the very purpose of quick arbitration, which is to provide a relatively efficient and informal means of private dispute res-

\textsuperscript{500} \textit{See infra} notes 682-87 and accompanying text.
\textsuperscript{501} \textit{Greenblatt v. Drexel Burnham Lambert, Inc.}, 763 F.2d 1352, 1355-60 (11th Cir. 1985).
\textsuperscript{502} \textit{Id.} at 1361.
\textsuperscript{505} \textit{Id.} at 90,378 (citations omitted). Judge Kram notes that the "appearance of bias that might disqualify a judge will not disqualify an arbitrator." \textit{Id.} at 90,377.
olution settlement."\textsuperscript{506}

However, this rationale seems to beg the question whether the goal of the securities regulation process is to protect the investor and the integrity of the marketplace. If so, it seems obvious that a written explanation of the findings would be called for in these quasi-judicial proceedings. To have one misapplication of the law is to leave the investor out in the cold, without recovery (or full recovery, as in this case). This result can hardly be said to comport with Congressional intent as expressed in the securities laws or, for that matter, in the Arbitration Act.

Another reason for the finality of the award is that the arbitrator does not have to give reasons for his decision.\textsuperscript{507} Even under the newly adopted SRO procedures, there is no mandate that the arbitrators give a "legal opinion" justifying their decision.\textsuperscript{508} The court "need not speculate on the arbitrator's reasoning process, for his analysis of the issues, and indeed, his grasp of even the rudiments of the controversy, are of no moment to the court."\textsuperscript{509} For this reason the courts will not require an arbitrator to be deposed, on the grounds that such discovery is a fishing expedition and would negate arbitration as a quick means to resolve disputes, and mean inordinate delay.\textsuperscript{510}

The finality of an award favors both the investor and the brokerage firm in most cases. For the investor who prevails, the award will be enforced by the SROs' internal mechanisms and sanctions, and in AAA and other arbitrations the investor will obtain confirmation of the award in court. In litigation, however, the possibility of appeal almost always exists for the losing party, with the attendant delay and expense.\textsuperscript{511}

3. Sanctions

A risk of sanctions pursuant to Federal Rule of Civil Procedure 11 exists when an attorney brings an action to vacate an arbitration award. In a recent case\textsuperscript{512} where the brokerage firm brought an action to vacate a $1,850,170 award, the court found the "zeal of an attorney who

\textsuperscript{506} Id. at 90,378 n.1 (citing Sobel v. Hertz, Warner & Co., 469 F.2d 1211, 1214 (2d Cir. 1972)).

\textsuperscript{507} This has been one of the complaints raised in securities arbitrations. See infra notes 681-82 and accompanying text. It is an advantage of arbitration. See supra note 51 and accompanying text.

\textsuperscript{508} See infra notes 681-83 and accompanying text.


\textsuperscript{511} See Krebsbach & Friedman, supra note 30, at 598. "It is the smaller investor who most benefits by arbitration and stands to lose the most by litigating his claims." Id.

lost the arbitration proceeding cannot overcome the lack of merit in the claims and the fact that objective counsel should have recognized the futility of the [appeal]."\textsuperscript{513} Finding the "challenge will not lie and indeed is antithetical to the very nature and purpose of arbitration—to obtain an expeditious, efficient and definitive resolution of controversies,"\textsuperscript{514} the judge imposed $25,000 in Rule 11 sanctions against the brokerage firm's counsel.

In a continuation of the \textit{McMahon} case, the McMahons asked a New York court to enjoin arbitration before the NYSE and compel it before the AAA instead. Shearson was granted a motion to compel arbitration and further state action was enjoined by the Southern District of New York on the grounds that the rationale of the McMahon's attorney was frivolous and flaunted the agreement, the Arbitration Act and the Supreme Court mandate. The filing of the first action did not defeat Shearson's right under the contract to demand NYSE arbitration if the McMahons did not do so within the contractual time period. They did not, and Shearson prevailed in selection of forum. Finding the action a "blatant evasion" of the court's ongoing jurisdiction and a misleading interpretation of the order, the court concluded the counsel's tactics "unreasonably, vexatiously, and frivolously multiplied these proceedings," justifying an award of sanctions.\textsuperscript{515}

\section*{VIII. Securities Arbitration}

\subsection*{A. SRO Forums}

Due to the nature of the securities industry and historical development, a number of different arbitration forums have developed. Forums for arbitration have been established by the SROs,\textsuperscript{516} including the New York Stock, American Stock and Chicago Board Options Exchanges (CBOE), the Municipal Securities Rulemaking Board and the National Association of Securities Dealers.\textsuperscript{517} In fact, the arbitration

\textsuperscript{513} \textit{Id.}
\textsuperscript{514} \textit{Id.}
\textsuperscript{517} "Securities Regulatory Organizations include the following members: American Stock Exch.; Boston Stock Exch.; Chicago Bd. Options Exch.; Cincinnati Stock Exch.; Midwest Stock Exch.; Municipal Sec. Rulemaking Bd.; National Ass'n of Sec. Dealers, Inc.; New York Stock Exch.; Pacific Stock Exch.; and Philadelphia Stock Exch." Katsoris, \textit{supra} note 489, at 3 n.1. All are registered with the SEC under the Exchange Act's market regulation purpose permitting the industry to develop self-regulation through organizations of broker-dealers. In the event a person engaged in the securities business is not a member of an SRO (which is highly unlikely), that person must register and be regulated as a "SECO" person (SEC only regulation). \textit{Id.} at 3-4 \& n.4.
\textsuperscript{517} The bulk of the arbitration is done by the NASD and NYSE. \textit{Id.} at 3 n.2.
clause may specify a single arbitral forum, although most jurisdictions permit either the customer or broker to select among the forums.\textsuperscript{518}

The SROs normally agree that members, those engaged in activities, including representing investors in trading, abide by the constitutions and rules of the body. The constitutions of the exchanges require members to arbitrate all disputes regardless of their nature.\textsuperscript{519} This means that a customer may force the firm to arbitrate before one of the SRO forums.\textsuperscript{520} Courts, even prior to \emph{McMahon}, interpreted this to permit arbitration because section 78bb of the Exchange Act\textsuperscript{521} permits the exchanges to mandate arbitration of Exchange Act claims\textsuperscript{522} and this falls under the "sophisticated investor" exception to \emph{Wilko}.\textsuperscript{523}

One feature of the SRO forums is that they may decide to reject a claim for arbitration.\textsuperscript{524} For example, the CBOE has a rule limiting arbitration to only CBOE matters, whereas the NASD will take stock options and commodity claims.\textsuperscript{525} The Uniform Code also permits the SRO to decline jurisdiction, "having due regard for the purposes of the [SRO] and the intent of this Code"\textsuperscript{526} and to dismiss proceedings "and refer the parties to the remedies provided by applicable law."\textsuperscript{527} Typically complex actions such as large and complicated class actions have

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\item[518.] The SEC prohibits arbitration agreements which limit customers to a single arbitration forum. SEC Lit. Rel. No. 12198, Fed. Sec. L. Rep. (CCH) ¶ 84,437 (Aug. 7, 1989). \textit{See} Roney & Co. v. Goren, Fed. Sec. L. Rep. (CCH) ¶ 94,438 at 92,826 (E.D. Mich. May 26, 1989), which held that an agreement specifying arbitration solely before the NYSE did not violate the Exchange Act's antiwaiver provision because the "substantial similarities" between NYSE and NASD arbitration procedures did not waive any substantial protection. The court felt that "the customer's ability to demand arbitration before the arbitral forum of his choice dictates that he is equally free to agree to limit his recourse to a particular forum." \textit{Id.} at 92,829. Again, it is essentially an issue of freedom of contract.
\item[519.] \textit{See} New York Stock Exchange, Inc., Constitution and Rules, N.Y.S.E. Guide (CCH) ¶¶ 151, 1555, 2347 (Jan. 1, 1979) (citing N.Y.S.E. Const. art. VIII, §§ 1 & 5; N.Y.S.E. Rule 347).
\item[520.] \textit{See} Scobee Combs Funeral Home, Inc. v. E.F. Hutton & Co., Inc., 21 Sec. Reg. & L. Rep. (BNA) 732 (D.C.S. Fla. March 2, 1989) (plaintiff relied on Section 12(a) of the NASD arbitration code which provided for arbitration on customer's demand or as provided in the written agreement; this section made the customer a third-party beneficiary of the firm's membership in the NASD).
\item[522.] No similar provision was inserted for 1933 Act claims. \textit{See} Fletcher, \textit{supra} note 29, at 426. He argues that, through triple misconstruction of \textit{Wilko}, only proper securities law claims are submitted to arbitration.
\item[523.] \textit{See} \textit{supra} note 187 and accompanying text.
\item[524.] \textit{See} 2 Am. Stock Ex. Guide (CCH), Am. Stock Ex. Const. art. VIII, § 2(a). "The Board of Governors may decide in any case to permit the use of the arbitration facilities of this Exchange."
\item[526.] Masucci & Morris, \textit{supra} note 60, at 406.
\item[527.] \textit{Id.} at 409.
\end{enumerate}
\end{footnotesize}
not been heard by SRO arbitrations.\textsuperscript{528}

Due to the possibility of selection of more than one forum under the provisions of most arbitration clauses prevalent in the securities industry, a number of cases have discussed the issue of forum selection. Most arbitration clauses provide that all relevant issues shall be consolidated in the same SRO forum under authority of the Arbitration Act, as applied by state law.\textsuperscript{529}

Before the Exchange Act amendments in 1975, which gave the SEC authority to oversee the arbitration activities of the SROs,\textsuperscript{530} the various arbitration forums applied different rules of procedure. As a result of SEC action in 1976, pursuant to this congressional mandate for the examination of the feasibility of developing a “uniform system of dispute grievance procedures for the adjudication of small claims,”\textsuperscript{531} and a staff recommendation for adoption of new procedures and creation of an independent entity to provide arbitration facilities in the securities industry, the SROs proposed an industry task force to examine arbitration. Another justification for the creation of the industry task force was that the volume of transactions would possibly generate many disputes. The industry had to develop a private forum to resolve them in order to avoid tying up vast sums of working capital in protracted litigation.\textsuperscript{532} Initially, the task force was to consider development of a uniform arbitration code in order to establish a more efficient mechanism for resolving investor disputes, especially those involving small sums of money.\textsuperscript{533}

The 1976 task force evolved into the Securities Industry Conference on Arbitration (SICA), established in April 1977.\textsuperscript{534} The SICA developed simplified arbitration procedures for resolution of small claims,\textsuperscript{535} which were the SEC’s announced concern. But the SICA then went on to develop, in many instances from already existing pro-

\textsuperscript{528} This is changing. For a discussion of complex litigation see Daily Report for Executives, \textit{infra} note 753.

\textsuperscript{529} \textit{See} Bock v. Drexel Burnham Lambert, Inc., 143 Misc.2d 542, 541 N.Y.S.2d 172 (N.Y. 1989) (consolidation is permissible where evidence and testimony are common to several arbitration proceedings under the authority of the federal Arbitration Act); Kanuth v. Prescott, Ball & Turben, Inc., Fed. Sec. L. Rep. (CCH) ¶ 94,430 at 92,752 (D. D.C. May 16, 1989) Employee initiated arbitrations before NASD and NYSE consolidated before NASD experience a real risk of conflicting awards that would “flout the strong federal policy encouraging arbitration. . . .” \textit{Id.} at 92,755.

\textsuperscript{530} \textit{See supra} text accompanying notes 167, 220 and 249.


\textsuperscript{532} Comment, \textit{supra} note 79, at 1381-82 (1988) (citations omitted).


\textsuperscript{534} For a more detailed description of the development of the SICA, see Katsoris, \textit{supra} note 39, at 362-64.

\textsuperscript{535} Initially small claims amounted to $2,500 or less. This has been raised in
1. The AMEX Window

One of the interesting features of SRO arbitrations is the provision in the American Stock Exchange Constitution which states: "(c) if any of the parties to a controversy is a customer, the customer may elect to arbitrate before the American Arbitration Association in the City of New York, unless the customer has expressly agreed, in writing, to submit only to the arbitration procedure of the Exchange." 538

Plaintiff’s attorneys have argued that, because the AAA is an available arbitral forum through this provision of the AMEX Constitution, the parties did not enter into an arbitration agreement providing that their disputes would be resolved only by AMEX or SRO arbitration. Attorneys for brokerage firms, on the other hand, argue that the AMEX Constitution does not provide authority for plaintiffs to resolve their claims at the AAA; it is an available forum only if designated in the parties’ arbitration agreement. 539 The issue of the "AMEX Window" has not been resolved in all cases. There are several cases now under consideration which bring the question of AAA election by a customer into review. 540 Twenty percent of the firms the SEC surveyed in 1987...

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537. Over 10,000 small claims had been submitted by 1988. Katsoris, supra note 39, at 368.


540. For a discussion of these cases see id. at 336-38.

In Pilch v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 21 Fed. Sec. Reg. & L. Rep. (BNA) 855 (D.D.C. June 14, 1989), the court found the clause valid, despite the fact that it was entered into in 1975, when the SEC was opposed to predispute arbitration clauses in customer agreements. Moreover, even though under the AMEX constitution a customer is permitted to elect to arbitrate before the AAA, customers can freely agree to proceed to arbitration before the AMEX, NYSE or NASD. The court declined to dismiss, however, staying the action pending arbitration.
include the AAA in their arbitration clauses.\textsuperscript{541}  

The practice under the arbitration clause of the customer agreement is to permit a very limited time for the customer to elect the forum.\textsuperscript{542} If the election is not made within that relatively short time, the brokerage firm can file a notice of election, usually of an SRO forum.\textsuperscript{543} Consequently, the AMEX Window election of AAA forum may be more of form than substance in practice. Two commentators noted:

It seems inconceivable that the AMEX, an SRO, could divest itself of jurisdiction over its members in favor of the AAA, a non-SRO, which does not utilize the Uniform Code of Arbitration employed by all SRO arbitral forums and is not overseen by the SEC. This is especially so when the parties' arbitration agreement designates solely SRO arbitral forums and does not mention the AAA. The Director of Arbitration of the AMEX, Scott Noah, Esq., in deposition testimony recently given in \textit{Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Hart}, has stated that the AMEX interprets Article VIII, Section 2(c) of its Constitution as \textit{not} providing authority for a public customer to commence an arbitration at the AAA. Notwithstanding the AMEX's interpretation, the AAA has stated that it will accept cases brought through the AMEX Window unless it is presented with a court order stating it has no jurisdiction.\textsuperscript{544}

The SEC filed an \textit{amicus curiae} brief in one case considering the AMEX Window,\textsuperscript{545} taking the position that the SRO rules permitting a customer choice of forum should take precedence over a brokerage firm's contract limiting the available forum.

The May 1989 SRO rule changes did not address the issue of the AMEX Window.\textsuperscript{546} They did, however, prohibit a brokerage firm from limiting or contradicting SRO rules in a customer's agreement. This seems to permit the continuation of the AMEX-AAA election.

In two recent decisions, the Southern District of New York found that the AMEX Constitution provision was not a "rule" which would create another arbitration forum in addition to the ones specified in the customer agreement and "closed" the AMEX window.\textsuperscript{547}

\textsuperscript{541} Fitterman, McGuire & Love, \textit{supra} note 27, at 178.

\textsuperscript{542} \textit{See, e.g., supra} note 5 (5 days after demand).

\textsuperscript{543} Epstenstein, \textit{supra} note 412, at 85; \textit{see also} Dyer, \textit{supra} note 539, at 338-44. There is also a short period to challenge arbitration—20 days after notice to arbitrate. N.Y. Civ. Prac. L. \\ & R. § 7503(c) (McKinney 1988).


\textsuperscript{546} \textit{See infra} notes 715, 767-81 and accompanying text.

B. American Arbitration Association

The AAA Securities Arbitration Rules were developed as a result of consultation with the securities industry. They provide for expedited hearings, if the amount in controversy is less than $20,000, and encourage mediation (where the mediator does not have the power to make a binding decision or award, but assists settlement negotiations between the parties under the AAA Commercial Mediation Rules). Otherwise, the rules are similar in procedure and panel composition to the other securities arbitration forums discussed above. \[548\]

One of the major advantages in AAA arbitration is that the AAA does not impose arbitrators on the parties. A list of potential arbitrators is furnished from whom the parties may strike those whom they do not want to sit. Typically, the AAA list is not skewed in favor of the industry with which the arbitration is concerned. If the parties desire, however, they may choose an arbitrator with industry expertise and experience. AAA arbitrators are not employees of the AAA and they usually serve pro bono for the first day of a hearing. Thereafter they are paid by the parties, on a per diem basis, through assessment by the AAA. \[549\]

Recently, an attorney raised the specter of American Stock Exchange Rules, which specify that a customer may “elect to arbitrate any dispute before the American Arbitration Association in the City of New York . . . .” \[550\] As might be anticipated, the broker in that case asked that the situs of the arbitration be the City of New York, which the rule seems to require. Such a location will be a considerable disadvantage to nationwide forums, now being provided by the SROs, and will be an additional financial burden for customers and their attorneys. The AAA has taken the position that the reference to New York City only refers to the main office of the AAA. It normally hears cases all over the country. \[551\]

A 1983 report, a study of 1,500 contract and tort cases (including 147 AAA cases) in five federal judicial districts, which were roughly divided equally between federal and state courts, made some startling discoveries. \[552\]

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548. See infra notes 581-88 and accompanying text contrasting the arbitration procedures in the AAA Rules and Uniform Code of Arbitration.
549. The present per diem in the New York Metropolitan area is around $500.
550. See Am. Stock Ex. Const. art. VIII, § 2(c); 2 Am. Stock Ex. Guide (CCH) ¶ 9063; see also Quinn, Case May Open Way for Independent Arbitration of Broker Disputes, Washington Post, Aug. 29, 1988, at F5, col. 1. See supra notes 544-47 and accompanying text for a discussion of the “AMEX Window.”
552. See Kritzer & Anderson, supra note 18, at 8-9.
— Only about five percent of court cases are fully litigated. 553 Over fifty percent of AAA arbitrations are fully adjudicated. 554

— Caseload and administrative factors affect the speed of adjudication in both the courts and AAA arbitrations, but “[o]verall, the AAA is not slower than the courts, and it is usually faster.” 555

— AAA arbitration is least expensive for small cases, but most expensive for cases in which over $20,000 is at controversy. The federal courts are least expensive for cases in the $5,000 to $10,000 range. State courts are least expensive in cases in which between $10,000 and $20,000 is at stake. 556

These results will probably extend to AAA securities arbitrations as well.

C. Other Arbitration Forums

In addition to the SRO and AAA tribunals, parties may submit their disputes to arbitration in a number of other places. These include the New York and other Chamber of Commerce Arbitration Departments, Better Business Bureaus, trade associations, and other groups. 557 However, there is no reason to permit the selection of an arbitration forum to sink to “forum shopping.” 558 For this reason, the uniformity of procedural rules in the SROs, as evidenced by the Uniform Code and its similar counterpart in the AAA Rules, is desirable.

1. Private Alternative Dispute Resolution

It is beyond the scope of this article to discuss the burgeoning industry now developing in alternative dispute resolution. Several for-profit corporations, with names like United States Arbitration & Mediation, Judicial Arbitration & Mediation, and Judicate Inc. have been formed in response to the crowded court dockets and high costs of lit-
Some use retired judges exclusively. Considering the present state of judicial salaries and the fact that such companies charge fees of $120 to $250 an hour for presiding over these private trials, one questions if this development is good for the current judicial system. But that is an issue for another article.

D. Arbitration Procedures

When a securities client seeks remedy for some perceived unfairness, or wrongful conduct by his or her broker, the first step is to evaluate the case from the viewpoint of arbitration. The type of document which forms the basis for the client/broker relationship will be the first inquiry. First, has it been signed by the client? Second, will it sustain challenge as a valid contract? If it is one of the typical customer agreements containing an arbitration clause, arbitration will be required. Then, the questions become what type of claim or claims can be made and where can they be resolved. As noted in the above discussion, even after Rodríguez de Quijas, although it may be possible to bring some claims in litigation, still others may have to be resolved in arbitration.

In any event, what are the types of claims that can exist in the broker-customer relationship? The following is a non-exclusive list of the types of claims which can exist in the broker-customer relationship and may be subject to resolution through the arbitration process:

1. 10(b) and Rule 10b-5 fraud;

559. See Wiehl, *Private Justice for a Fee: Profits and Problems*, N.Y. Times, Feb. 17, 1989, at B5, col. 3. This article notes that there are more than 50 such companies specializing in resolving corporate disputes.

560. For example, a husband’s agreement to arbitrate disputes in any brokerage account in which he had an interest did not bind his wife in her separate account since she did not sign the agreement. This was so even though he had been authorized by her to act in a joint account. Any problems arising between the wife and the brokerage firm regarding either the joint account or her separate account would not be affected by the husband’s agreement. Dillard v. Cooper, Fed. Sec. L. Rep. (CCH) ¶ 94,521 (W.D. Okla. 1989).

561. See supra notes 322-427 and accompanying text.

562. See supra note 3 for form of clause normally used.

563. In the presentation of this material in arbitration procedures, the author has relied on the materials of Mr. Robbins from Robbins, supra note 3, at 49-66, Robbins, supra note 208, and Robbins, *Securities Arbitration: Preparation and Presentation*, 42 ARBITRATION J. 3 (June 1987).

One source for information regarding the brokerage firm’s employees, who are often the focus of these claims, is the NASD information office on public disclosure of information on disciplinary and other actions concerning member firms and associated persons. See Robbins, supra note 34, at 133.

564. Most claims are for fraud. Approximately 50% of all NYSE complaints involve unauthorized trading. Churning and suitability are also common. RICO claims are becoming more prevalent. Hoblin, *Broker/Dealer Response to Customer Complaints In Arbitration*, PRAC. L.I. RESOLVING SECURITIES DISPUTES 327-28 (1986).
(2) RICO;
(3) Blue Sky Law;\textsuperscript{565}
(4) Common law fraud for misrepresentation;
(5) Breach of contract;
(6) Unsuitability;\textsuperscript{566}
(7) Churning—control and excessive trading issues;
(8) Unauthorized trading;\textsuperscript{567}
(9) Omissions;
(10) Margin account-liquidation and margin calls;
(11) Order failure or mistaken orders;
(12) Broker ignorance in areas "too dangerous and too complicated";\textsuperscript{568}
(13) Forgery;\textsuperscript{569}
(14) Breach of fiduciary duty owed to the customer;
(15) Failure to supervise employees by the brokerage firm; and
(16) Insider trading.

When is it time to get a lawyer? Before this, it may be possible for the investor to work out the problem within the brokerage firm's grievance procedures. Typically a customer will complain to the broker and receive little or no relief. He or she will then complain to the office manager, perhaps with the same result. Finally, the customer should write to the compliance department of the firm. If, after the firm's internal investigation, no relief is offered or the offered relief is unacceptable, the customer will then consider whether to get a lawyer or not. But this also may depend on what relief is desired. There are circumstances where an attorney is not warranted. Moreover, an attorney is not necessary and a claimant can be represented in arbitration by a friend, financial advisor, accountant, or other representative.\textsuperscript{570}

\textsuperscript{565} See, e.g., Uniform Securities Act § 101.
\textsuperscript{566} The concept of "suitability" derives from the obligation of a broker to "know your customer." Brokers are not obligated to do business with anyone who walks through the door and have a duty to not do business with those judged to be unsuitable or poor credit risks. Much of the brokerage business is done on the basis of an oral agreement—a telephone call ordering or selling thousands of dollars of securities. This "know your customer" rule, in turn, requires the broker not to sell securities to a customer which are unsuitable for his or her investment objectives and risk-taking ability. See N.Y.S.E. Rule 405, N.Y.S.E. Manual (CCH) ¶ 405; NASD Rules of Fair Practice art. III, § 2, NASD Manual (CCH).
\textsuperscript{567} See Cotter v. Shearson Lehman Hutton Inc., 21 Fed. Sec. Reg. & L. Rep. (BNA) 851 (S.D.N.Y. June 4, 1989) (dispute as to whether the plaintiffs authorized options trading in their accounts was within the arbitration clause to be determined by arbitrators, not court).
\textsuperscript{568} See Ricks, \textit{SEC Chief Calls Some Financial Products 'Too Dangerous' for Individual Investors}, Wall St. J., Jan. 7, 1988, at 46, col. 5. "There may be products too dangerous to be suitable." \textit{Id.} (statement of Chairman Ruder).
\textsuperscript{569} See \textit{supra} notes 421-22 and accompanying text discussing forgery claims.
\textsuperscript{570} Uniform Code of Arbitration, \textit{supra} note 536, § 15; AAA Rule 22, \textit{supra} note 31.
If the claim is less than $25,000, few attorneys will take the case, unless attorney’s fees and costs can be part of the recovery, as in a RICO action, for example. The predispute arbitration clauses will not cover the recovery of attorney’s fees and costs by the customer. It is not likely that the contract between customer and broker will be drafted to provide for recovery of attorney’s fees and costs in event of a breach.

The Uniform Code, adopted by the Securities Industry Association Committee on Arbitration in 1979, approved by the SEC in 1979, and adopted by all SROs in 1979 and 1980, specifies a small claims procedure for claims of less than $10,000, which is especially designed for the pro se claimant.571

Common failings of pro se claimants include generalized and unsupported statements of the claim; failure to read and understand the answer; failure to prepare properly for the hearing; intimidation, both by the forum and process, as well as the presence of the broker’s counsel; lack of litigation skills, such as knowledge of the procedures to subpoena witnesses and documents, cross examination, and inability to use expert witnesses. Generally, pro se claimants tend to present a case on emotion, not facts and law.572 Even in small cases it may be advisable to retain an attorney to draft the complaint or submission. Once a claim goes to arbitration, the procedure is standardized by the Uniform Code or AAA Securities Arbitration Rules.

1. Bringing the Claim; Location of Hearing

A proceeding is commenced in SRO or AAA arbitration by the Statement of Claim573 or Demand.574 A Uniform Submission Agreement575 may also be used, but this will bind the executing parties to any award, including decision on counterclaims. The filing fees are set by the SRO576 or AAA.577 The locale for arbitration depends on the fo-

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571. Uniform Code of Arbitration, supra note 536, §§ 13, 27. This dollar limit was changed several times, the last time in 1989. The director of Arbitration, under § 27 of the Uniform Code, is permitted to select only one arbitrator for claims between $10,000 and $30,000, unless the parties disagree. Id.

In fact, panels are felt to be more generous to the pro se claimant where the amount in controversy is small, unless the claimant representing himself is a lawyer (a lawyer is presumed to have more knowledge than a layman). See Robbins, supra note 3, at 68.

Expedited procedures are provided for claims not exceeding $25,000 under AAA Rules §§ 53-57. See AAA Rules, supra note 31.

572. See Robbins, supra note 3, at 69.


574. AAA Rule 6, supra note 31.


577. See AAA Rule 48, supra note 31.
AAA arbitration will permit the parties to agree on the place, but in SRO arbitrations, the director of arbitration will decide on the first hearing place and the arbitrators will decide for subsequent hearings. The SROs conduct hearings regularly in many locations throughout the United States and Puerto Rico. The AAA has 34 regional offices. Claims can be filed in any office in the forum.

2. Securities Industry Arbitration Panels

The arbitration panels will be determined by the customer’s agreement terms, or submission agreement. SRO panels provide for one arbitrator for claims up to $10,000, three for claims up to $500,000, and five for claims in excess of $500,000. Although prior to 1987 no industry panelists were present on AAA selection lists, today in AAA arbitration each party will be given two lists, industry and non-industry arbitrators, from which to select the panel. Two arbitrators are appointed from the non-industry list and one from the industry list. If the claim is less than $20,000, then only one non-industry panelist will be selected.

Two questions are continuously raised regarding SRO arbitrations: (1) is the proceeding biased in favor of the industry-member of the SRO; and (2) are there too many arbitrators with industry affiliations? In response to the first question, the SRO provides the facility and personnel to process the arbitration. The personnel do select the arbitrators, but have little input into the process, and will not advise on issues of substantive law or participate in the deliberations of the panel. In fact, the personnel of the SRO will often assist the pro se claimant in the presentation of his or her materials to the panel, through advice about the procedures and process (outside the hearing, of course).

a. Bias—A Perception Problem or Grounds to Challenge?

One of the major problems in the perception of the public regarding industry sponsored arbitration is the impression of bias of the panel. The parties in arbitration are "not only entitled to present

580. In 1988, the NASD conducted hearings in 52 cities and the NYSE in 33 cities. Robbins, supra note 34, at 34.
581. Uniform Code of Arbitration, supra note 536, § 8 was amended in 1989 to provide for 3 panelists in all cases over $10,000. Today under NASD Code § 19 and NYSE Rule 60, there is one arbitrator for claims of $10,000 or less; and 3 for all others (except one in NASD arbitrations up to $30,000 unless claimant requests 3 and 3 to 5 if claimant requests for all other cases).
582. AAA Rules 13, 17 and 54, supra note 31.
583. AAA Rule 13, supra note 31.
[their] claims to an impartial judge, but to one who by no act on his part has justified a doubt as to his impartiality.” 584 While non-neutral arbitrators may be permitted under the Arbitration Act through agreement or consent of the parties, arbitrator bias is one justification for setting aside an award. 585 An arbitrator must disclose any past or present relationship with the parties which might create an impression of possible bias. 586 This extends to both business and personal dealings. 587 Justice White stated in his concurring opinion in a 1968 case that “[a]rbitrators are not automatically disqualified by a business relationship with the parties before them if both parties are informed of the relationship in advance, or if they are unaware of the facts but the relationship is trivial. I see no reason automatically to disqualify the best informed and most capable potential arbitrators.” 588

In fact, presumptively biased arbitrators may nonetheless make the best arbitrators, if the arbitration requires industry expertise, and they are the unimpeached experts in the field. In Mitsubishi Motors v. Soler Chrysler-Plymouth, Inc., the Supreme Court noted that “adaptability and access to expertise are hallmarks of arbitration. The anticipated subject matter of the dispute may be taken into account when the arbitrators are appointed, and arbitral rules typically provide for the participation of experts either employed by the parties or appointed by the tribunal.” 589

Impermissible arbitrator bias is best described as requiring actual bias in the process. Because each party has the right of procedural due process, the right to have a “realistic and fair opportunity to prevail in the dispute” 590 is guaranteed. This minimal level of integrity of the process requires that the arbitrator both disclose any conflict, or appearance of conflict of interest, as well as be capable of deciding the

585. See 9 U.S.C. § 10(b). See supra notes 473-86 and accompanying text for a discussion regarding ways to set aside an award of the arbitrators. See also Note, supra note 328, at 1022-25.
587. See Note, supra note 328, at 1022-23 (citing Johnston v. Security Ins. Co., 6 Cal. App. 3d 839, 86 Cal. Rptr. 133 (2d Dist. 1970)) (even though the state statute did not provide for vacatur due to bias, the award was vacated due to the arbitrator’s undisclosed acquaintanceship with the plaintiffs’ attorney-appraiser).
588. Commonwealth Coatings, 393 U.S. at 150 (White, J., concurring).
589. Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 633 (1985). This attitude is a considerable change from Wilko in 1953. In addition, many arbitrators are lawyers specializing in securities litigation or practice; “[o]ther arbitrators are sophisticated business or accounting executives financial consultants, and college deans or professors.” Bedell, Harrison & Harvey, supra note 55, at 8.
case on the basis of the evidence presented. A more direct bias might be the case if the arbitrator had a personal or financial interest in the outcome.

Situations which typically find the existence of bias include those where the arbitrator is a party to the proceeding, or is related by consanguinity, affinity or business (including employee, agent, employer, debtor, creditor, attorney, or client). This is not necessary under the AAA process, since the parties select the panel themselves from lists provided by the AAA. In SRO arbitrations, challenges become another ground for the parties to affect the perception of fairness. Under all rules there is challenge for cause and one peremptory challenge for each party. One of the problems is that panels are normally not determined until just shortly before the arbitration. Under the SRO rules adopted in May 1989, there is a short notification period. This, of course, limits the ability to make an informed challenge. If a vacancy occurs in a panel, the director of arbitration can fill the vacancy, but a challenge procedure and disclosure regarding the replacement are permitted.

The controlling question on a motion to vacate an award, however, is whether the interest was disclosed to the parties. If the parties proceeding in arbitration either knew, or should have known, of the potential bias, there will be a waiver and the award is impregnable.

If the nature of the bias is industry connected, however, the courts


592. This would seem to require both an interest that hinges on the outcome and is substantial enough to influence the arbitrator’s decision. See Note, supra note 328, at 1033.

593. See Comment, supra note 306, at 339-40. “Relationship by consanguinity, affinity or business, i.e., servant, employee or agent, of debtor and creditor and attorney and client if unknown to the other party may cause disqualification.” Id. (citations omitted).

594. NASD Code of Arbitration Procedure § 22; N.Y.S.E. Rule 602(e).

595. Each party may strike names from the AAA panel, returning the remaining names with an order of preference. The arbitrators are selected on the basis of highest mutual preference.


598. See infra note 773.

599. Under the old SRO rules, a replacement arbitrator was not subject to challenge, but the parties could start the arbitration all over again with a new panel if they desired.
have a harder time vacating an award or staying arbitration. In some instances, they will find the arbitration clause unenforceable as being adhesive.\footnote{600} Potential industry bias, however, is not sufficient to disqualify the forum itself.\footnote{601} In other cases there may be institutional pressure exerted on the arbitrator, either overtly or covertly, to render a decision in favor of one of the parties. When the institution has control of the arbitrator selection as well as forum for arbitration, bias can almost be presumed.\footnote{602} This would certainly be the case, for example, if a broker had set up his own captive forum, using his own employees, or former employees, on variable or discretionary pension, or paid arbitrators, and then required customers to submit disputes to this panel.\footnote{603} It is clear that minimal levels of integrity would not be satisfied in this event.

Even if there is an appearance of bias, there is no guarantee that the bias will be sufficient to vacate an award or disqualify a forum. Membership in the same organizations, personal acquaintance, work referrals without payment, and past business dealings are not enough to create the necessary bias.\footnote{604} This is particularly true if the parties have the right under the rules of the forum to disqualify a certain number of arbitrators as a matter of right, and the right to disqualify all who show the requisite potentiality for bias.\footnote{605}

\footnote{600} Of course, if the industry or firm sponsored arbitration process requires the use of presumptively biased arbitrators, it will be found unconscionable. See Note, supra note 328, at 1037-38. See supra notes 327-63 for a discussion of adhesion contracts.

\footnote{601} See Note, supra note 328, at 1024 (discussing Arrieta v. Paine, Webber, Jackson & Curtis, Inc., 59 Cal. App. 3d 322, 130 Cal. Rptr. 534 (1976), to the effect that the customer had opportunity to disqualify biased arbitrators and potential bias is not a ground for vacatur of award). But see discussion of Hope v. Superior Court, 122 Cal. App. 3d 147, 175 Cal. Rptr. 851 (1981), which relied on Graham in holding that the NYSE arbitration procedure was unconscionable. Note, supra note 328, at 1046-47. The commentator concluded that there is “danger of over-intrusive lawmaking by courts armed with substantive unconscionability. . . . Moreover, courts are not competent to evaluate the fairness of the arbitration . . . .” Id. at 1046.

\footnote{602} Note, supra note 328, at 1034.

\footnote{603} See Note, supra note 328, at 1034 n.111 for example of forum where one neutral and two non-neutral arbitrators must, under the rules, decide claim by a unanimous vote. Since decisional (or veto) power is exercised by one biased arbitrator, the process fails as not meeting the minimal levels of integrity. Id.

\footnote{604} Note, supra note 328, at 1035-36.

\footnote{605} The Uniform Code of Arbitration, supra note 536, § 22, provides one challenge without cause for each party and unlimited challenges for cause. The AAA Rules provide for arbitrator selection from many choices. See supra note 595 and accompanying text.

In a private arbitration clause, the courts retain the right to appoint an arbitrator when the arbitration clause is silent on the matter, or when a vacancy occurs in the named arbitrators. See 9 U.S.C. § 5 (1988); Krause, supra note 382, at 698 n.26.
b. Disclosure of Bias

As in the SRO arbitrations, where the forum selects the arbitrators, a perception that the institution-sponsored forum is biased can be considered almost presumptive. This is especially true if there is limited disclosure to the non-industry parties of the backgrounds and affiliations of the arbitrators for the purpose of challenging an arbitrator being empaneled. The use of such a presumptively biased forum, would certainly permit a court’s review of the process and outcome, or award.  

The disclosure regarding arbitrators was one of the major concerns of the SEC after McMahon. The disclosures to non-industry parties of the nature of the contacts of the proposed panels is important to improve the impression that the SRO forums are impartial.

The NYSE and NASD established procedures in 1988 whereby disclosures regarding employment histories of the arbitrators, and other pertinent information, is sent to the parties before the arbitration begins. These procedures resulted in SRO rule changes approved by the SEC in May 1989.

The SICA has completed a guide outlining the arbitrator’s duty to avoid any appearance of bias through full disclosure throughout the proceeding, the arbitrator’s ethical responsibilities, the procedure under the Uniform Code, and the role of the arbitration staff.

c. Classification of Arbitrators

Under the Uniform Code, arbitrators are chosen from two lists—public arbitrators and industry arbitrators. The NYSE has adopted guidelines giving a precise definition distinguishing between public arbitrators and industry arbitrators. These guidelines comply with the amendments to NYSE Rule 607 defining industry arbitrators as compared with public arbitrators. It is clear, however, that the practice

606. See Note, supra note 328, at 1044. “Courts are competent to measure the fairness of [arbitration] . . . because procedural fairness is part of the judicial trade . . . .” Id. (citations omitted).


608. See N.Y.S.E. Rule 610 and Rule 608, amended to require disclosure of any potential conflict and employment history, respectively. N.Y.S.E. Rules 608, 610, N.Y.S.E. Manual (CCH).

609. See infra note 767 and accompanying text.

610. NASD Code of Arbitration Procedure §§ 8(a)(1) and (2) provide that a public customer dispute shall be resolved by a panel “at least a majority of whom shall not be from the securities industry.” On the other hand, disputes among member firms can be resolved by industry-only panels.


612. See id. at 234. The major change in NYSE Rule 607 is that a person
of the SROs is different in classifying arbitrators.

3. Training Arbitrators

As noted above, the use of experts is one attribute of arbitration in difficult cases. In the securities area, with the complicated nature of the marketplace and the complex mix of different rules of law, a degree of expertise is essential.

Until recently, most of the SROs have not had training programs for arbitrators, relying instead on a belief that the panels from which they select arbitrators have sufficient expertise, or that the parties will elect to disqualify a person whose disclosures indicate they are not sufficiently well qualified to sit. Nevertheless, some change is taking place. Both the NASD and NYSE have held training sessions for arbitrators. The NYSE used a tape prepared by the AAA for assistance to arbitrators generally. The NASD has held 21 educational forums in 1987 and 1988. The American Law Institute-American Bar Association Committee on Continuing Professional Education has developed, and offers to interested viewers, a videotape entitled *A Guide to the Discovery Rules for Securities Arbitration*. The SICA is developing a manual covering "the ethical responsibilities of arbitrators, the conduct of the hearing, discovery, motions, and the special authority of arbitrators."

4. Evaluation of Arbitrators

One troubling issue now confronting the SROs is the SEC's request for "evaluation" of the members of arbitration panels. First, there is uncertainty regarding the scope of the SEC's requested evaluation: Does it go toward establishing a "track record" of wins and losses for the investor versus the broker; or is it toward determining the qualifications of the arbitrator, based on his participation in the process as evaluated by the parties, or others? For the integrity of the process to hold, the evaluations should not become a "popularity contest," with votes associated with a member or other investment house is an insider if he has been associated in the last five [NASD and Uniform Code § 8 use three] years; is a retired person who spent "a substantial part of his or her business career" in the industry; is an attorney, accountant or other professional who devoted twenty percent or more of professional work to clients in the securities industry in the last two years; or has a spouse or other member of the household who is a person associated with the industry. N.Y.S.E. Rule 607 (2) and (3). Otherwise, one is a public arbitrator. N.Y.S.E. Rule 607 (3), N.Y.S.E. Manual (CCH).

613. See *Schropp, Securities Arbitration, New Approaches to Securities Counselling & Litigation After McMahon* 141-53 (1988). This was primarily a result of the SEC's 1987 letter to the SICA. See *infra* notes 642, 747.


cast after the award by the victorious or losing party. At the present time there is an informal evaluation process, in the nature of selection of arbitrators from the panels by the SRO arbitration personnel. It appears that this process works well. Further, to identify arbitrators (like many labor arbitrators) as “pro-industry” or “pro-investor,” will not be good. Arbitrators may try to protect their independence by looking at the decisions they are about to make and their “record.” There is reason to suspect that such classifications already exist, due to the publication of awards under the new SRO rules.

Consequently, the minimal levels of procedural due process must be decided on a case-by-case basis, with the courts examining the bias of arbitrators, as well as the fairness of the private dispute resolution forum.

5. The Present Situation

There is no reason to suppose that non-SRO facilities and procedures are any less cost-effective. For this reason, there may be rationale to provide arbitration forums which are not affiliated with the industry, in order to provide the appearance of fairness and an unbiased system for dispute resolution. Despite the author’s impression, based on his participation as an arbitrator, that the personnel of the SRO are scrupulously fair, the impression of bias still remains in the mind of the customer, who is forced by the forum selection clauses of the predispute arbitration agreement to choose between two equally undesirable SRO-sponsored forums. This can be resolved by permitting choice of AAA or other forums. The best solution for the industry would be to establish a single forum for arbitration, unaffiliated with any exchange or broker-dealer organization. The appearance of impropriety could thus be eliminated.

The SEC and commentators have raised several questions regarding the affiliation of arbitrators. Presently, the courts will presume that the arbitrators are fair and unbiased. Based on this author’s arbitration experience, the presumption is correct. Industry and retired industry personnel, in fact, seem most outraged at industry conduct which is not in accord with the fair and equitable standards by which brokers are to treat their customers. While taking an oath to be impartial is no guarantee of impartiality, it is nevertheless, another indication of a fair deliberation.

The SEC proposed a number of changes in the area of selection and training of arbitrators. For example, retirees, who spent a majority

617. See Katsoris, supra note 39, at 379-80.
618. Id. at 380.
619. See supra note 328 and accompanying text.
620. See SEC letter of September 10, 1987 to all SROs, discussed further in text at infra notes 642, 747. This letter has been reprinted in Eppenstein, supra note
of their careers in the industry, and lawyers and accountants, who regularly provide services for a fee to the industry, should be designated as industry and not public arbitrators; so should their spouses. The SEC has also asked the SROs to consider evaluations of the arbitrator's competence, preparedness and fairness; arbitrator training, which was virtually non-existent until 1988; disclosure requirements of relationship or conflict of interest with a party involved in the proceeding; creation and preservation of a record of the hearing; and, finally, complex and large cases should be treated differently.

6. SEC Approval of SRO Rule Changes

In May 1989 the SEC approved sweeping rule changes, proposed by the SICA through application of the SROs which offer arbitration facilities. These rule changes deal with a host of issues raised in the above discussion, but do not address all the concerns regarding industry-sponsored dispute resolution. The rule changes will be discussed later in this article. Other areas of concern continue to exist.

One of the continual concerns of the SEC staff is that customers be made aware of other arbitral forums, especially the AAA. Minor concerns for the future include the ability of arbitrators to enforce interim decisions, especially in discovery, and review of the handbook acquainting arbitrators with the process, rules and law.

In a related SRO rule change approval, the SEC acted on the request of the CBOE to change rules concerning service of pleadings, selection of arbitrators, disclosure of arbitrators' background, discovery and publication of award summaries similar to the changes previously


621. Several panels have considered arbitrator training since the SEC's letter of September 10, 1987. The NASD encouraged attendance at a seminar held in Florida in Fall 1988 and held 22 general training sessions. The NYSE held a training session in Spring 1988 to which all arbitrators were invited. The topic has been covered in other seminars, although these are not, technically, training for arbitrators.

622. Most SROs do not, like the NYSE, transcribe hearings before a court reporter. The NASD tape records the hearing. See infra notes 661 & 709 and accompanying text.

623. The SRO forum can decline to accept the case under the rules of the organization. See supra note 524 and accompanying text. In addition, arbitration procedures could be modified from the norm to permit prehearing conferences, stipulations could be used to establish uncontested facts, and the process can respond to the needs of these kinds of cases. There is no reason to believe that arbitration is an inappropriate forum just because of the size or complexity of a case.

624. See infra notes 708, 720-25 and accompanying text.

625. Id.
approved for the NYSE, AMEX and NASD. Continuing its practice, the CBOE also required highlighting of the arbitration provisions and an explanation to customers of their rights vis-a-vis mandatory arbitration agreements.

The SEC staff is working with the SROs on two other areas of concern. First, class actions have not been well addressed by the arbitration rules. Second, some matters are thought to be too complex to be handled by any adjudicator other than the courts. In line with the discretion to refuse a complex matter, the SROs consistently do not hear class actions.

7. Fees

As noted in the ABA Task Force Survey, arbitration is normally regarded as being cheaper than litigation. This is not always true. In fact, the filing fees in arbitration are probably much higher than filing fees in state or federal courts. The fees charged for securities arbitration vary depending on the SRO forum, and are subject to SEC supervision. In comparing the forums, there is a considerable difference between SRO and AAA fees. This is principally due to the subsidization of the SRO process by the members of the exchange or broker-dealers.

NYSE and AMEX arbitration fees in public cases range between a fee of $15, for a claim or counter-claim in the amount of $1,000 or less, to a fee of $1,000, for disputes over $500,000. Additional charges are made for hearing sessions. This can quickly add up to much more than litigation fees. In the absence of a dollar amount in dispute, a $200 fee is assessed. The arbitrators may include in the award an assessment of forum fees to the parties as they determine.

Under the AAA Securities Arbitration Rules, fees are also assessed based on the amount of the claim or counterclaim. For claims up to $25,000, there is a minimum fee of $300 or 3% of the amount of the

626. See infra notes 681-84 and accompanying text.
627. See statements of Catherine McGuire, special assistant to the Director, and Robert Love, special counsel, Division of Market Regulation, reported in 21 Sec. Reg. & L. Rep. (BNA) 684 (May 14, 1989). Love noted that "no arbitrator has handled a class action"; one such suit was settled after submission. Id.
628. See supra note 27.
629. New York State filing fees are typically $1, with additional fees for requests for judicial action. See N.Y. Civ. Prac. L. & R. § 8016(a) (McKinney 1988).
630. See supra note 3 and accompanying text.
631. N.Y.S.E. Rule 629; Am. Stock Ex. Rule 480(a)(d); NASD Code of Arbitration Procedure § 43.
632. N.Y.S.E. Rule 629(d).
633. See N.Y.S.E. Rule 629. There are different fees for member controversies (see N.Y.S.E. Rule 631).
claim, whichever is greater. For claims of between five and fifty million dollars, there is a fee of $14,250 plus one tenth of one percent of the amount of the claim which exceeds five million dollars. If no claim amount is stated at the time of filing, the fee is $750.634

In order to discourage adjournments, there is a small adjournment fee, payable by the party causing the adjournment of any scheduled hearing.635

Fees are typically paid prior to the commencement of the hearing, but in appropriate cases the administrator can waive the fee payment to a later time.636 If a case is settled or withdrawn, a refund of a portion of the fee is made.637

8. Responding to a Claim

Under AAA rules, the respondent is not required to file an answer.638 Under SRO arbitrations, however, general denials or failure to submit an answer within the rules may bar presentment of any facts or defenses at the hearing.639

An arbitrator looks upon a non-responsive [answer or no response] in a number of ways: (a) not important enough to warrant time to answer; (b) accepted the claim as presented; (c) leaves the arbitrators free to conclude their own findings; (d) is usually accepted as an admission of guilt; and, (e) wastes valuable time of all parties involved.640

9. Preparing for the Hearing

There is normally a period of several months before the hearing. The arbitration forum personnel will arrange for service of the claim, answer and other matters during this time. There is no discovery as contemplated under the Federal Rules of Civil Procedure.641 But the SRO rules now provide for "voluntary exchange" of documents which will serve to " expedite the arbitration."642

634. AAA Rules Fee Schedule, supra note 31.
635. See AAA Rule 57, supra note 31 (fees for adjournment in sole arbitrator cases are assessed against the party causing the adjournment in the amount of $50 for the first and $100 for additional adjournments; with three arbitrators the fees are $75 and $150).
636. NASD Code of Arbitration Procedure § 43; N.Y.S.E. Rule 629; AAA Rule 48, supra note 31. In hardship cases the fees may be completely waived.
637. In AAA cases, the refund amount depends on whether the list of arbitrators has been sent out or not. AAA Rules Refund Schedule, supra note 31.
638. AAA Rule 6(b), supra note 31.
639. Uniform Code of Arbitration, supra note 536, § 13; NASD § 25(b); N.Y.S.E. Rule 612(c).
642. See Mandel, Arbitration Discovery, in Securities Arbitration Update 38, 46-
The discovery process in arbitration is more limited than in judicial actions. Arbitrators can subpoena witnesses under the Uniform Code, the Arbitration Act, and most state arbitration statutes, but enforcement is left to the judiciary in the event the subpoena is not observed after service.

Under the new SRO rules as approved by the SEC in May 1989, discovery is now permitted under the SRO rules themselves. While the issuance of subpoenas and voluntary exchange of information was permitted under prior practice, the new rules permit depositions and discovery as well as providing a forum for determining issues of disclosure—the prehearing conference. A single arbitrator appointed by the director of arbitration will decide these matters of discovery on written submission or at a hearing. Depositions will be routinely permitted.

This procedural change is overdue. The arbitrators are given the powers to accomplish discovery, and the courts will be reluctant to

49 (M. Fitterman & T. Krebsbach eds. 1989) for NYSE Rule 638 requiring parties to exchange documents and proposed rule revisions. A new proposal by the SICA to provide for more extensive prehearing discovery as a result of SEC criticism has been prepared and was adopted in May 1989. See infra notes 747, 771 and accompanying text and earlier discussion of this issue in Ketchum letter of September 10, 1987 to all SROs, reprinted in Eppenstei{n, supra note 412, at 91-103, in Fitterman, McGuire & Love, supra note 620, at 279-91, and in A. ROBBINS, AN INSIDER'S GUIDE TO SECURITIES ARBITRATION 14 (1985). See also SICA letter of December 14, 1987 to Mr. Ketchum, reprinted in Fitterman, McGuire & Love, supra note 620, at 293-303

643. subpoena ad testificandum.

644. subpoena duces tecum.

645. § 20(a); NASD Code of Arbitration Procedure § 32; N.Y.S.E. Rule 619. But this is limited to subpoenas which would be permitted under applicable laws. See N.Y. CIV. PRAC. L. & R. § 7505 (McKinney 1980). It is also limited to SRO members and associates. Presently there is no way to determine compliance until the prehearing conference or hearing when the persons or documents must be produced.


648. See Page, Subpoena Practice in Arbitration, in Wide World of Arbitration 32 (AAA ed. 1978); See also supra note 523. One commentator notes, however, [t]he failure of a broker-dealer party to an arbitration to produce documents, under certain circumstances, may be deemed inconsistent with SRO rules requiring that their members conform with just and equitable principles of trade. There is no corresponding penalty for the failure of a public customer to comply with discovery requests. However, there is a risk for either party of being assessed costs for a postponement of the hearing resulting from one party's failure to produce documents in a timely fashion.

649. See infra notes 761-75 and accompanying text.

650. NASD § 32; N.Y.S.E. Rule 619.

651. See infra notes 655-56 and accompanying text.
grant requests to aid arbitration discovery where the arbitrators have refused such requests previously. The arbitrators are in the best position to judge the relevance of discovery requests as opposed to a mere disagreement as to the relevance of documents and witnesses. Consequently, because of the arbitrators' decision-making discretion, a losing party will not normally be able to vacate an award due to the arbitrators' conduct.

The composition of panels and information regarding the industry connections of the potential panelists were of major concern to the SEC, and resulted in many of the May 1989 SRO rule changes. "Arbitrator profiles," which give an extensive biography of the arbitrators selected by the SRO for a given case, are being sent to parties.

10. The Pre-Hearing Conference

The AAA Rules provide for a pre-hearing conference at the parties request or at the discretion of the AAA. This provision applies in large or complex cases to specify the issues to be resolved and to stipulate uncontested facts; schedule for document production; identify witnesses; schedule hearings; and consider other matters to expedite the arbitration proceedings. The revised rules of the SICA also provide for such hearings at the request of a party, an arbitrator or the director of arbitration.

11. The Hearing

The arbitration normally begins with the arbitrators taking an oath to hear and decide the controversy faithfully and fairly. Since arbitration is a private proceeding, only the parties are present. Witnesses can be excluded upon request by a party. The arbitration can proceed without a party, providing there is jurisdiction over him and he has been properly notified of the hearing. Interim relief is permitted if deemed necessary to protect the property that is the subject matter of

654. See Robbins, supra note 3, at 97.
655. AAA Rule 10, supra note 31.
656. In March 1988 the SICA approved a similar pre-hearing conference rule. The prehearing conference was codified by the May 1989 SRO rule changes approved by the SEC.
657. AAA Rule 27, supra note 31.
658. This may present a problem if a party wishes an expert witness to be present to listen and evaluate testimony. This decision will be made by the arbitrators. Robbins, supra note 3, at 101.
659. The party must have been notified of the hearing, not just the proceedings.
the arbitration pending the final outcome of the proceedings.660

Under the newly approved SRO rules, a verbatim record by court reporter or tape of all arbitration hearings is to be kept.661 The party requesting transcription of the record must pay for it unless the arbitrators direct that the record be transcribed, which usually will occur only in multiple sessions with complex facts or legal issues.662

Adjournments are permitted in the discretion of the arbitrators. Frivolous, last minute requests for adjournment are discouraged by the imposition of adjournment fees in SRO arbitrations.663 Courts have vacated awards, however, where the arbitrators refused to grant a legitimate adjournment request.664

Rules of evidence are not applied in arbitration because the "sophistication of the arbitrators is such that they should be able to delineate the probative from the prejudicial . . . [and] therefore, determine the materiality and relevance of any evidence presented."665 The award must be based, however, only on the evidence presented and not as a result of the arbitrator’s special knowledge. This informality, coupled with a less adversarial nature, are two real advantages of arbitration over litigation.

Affidavits are permitted in lieu of testimony, but are given whatever weight the arbitrators decide.666 Witness are normally sworn.667

"The parties are entitled to be heard, to present evidence and to cross-examine witnesses."668 The order of proceedings are opening statements, the claimant’s presentation of case which is subject to cross examination and questions from arbitrators,669 respondent’s presentation and cross, panel inquiry as to the completeness of the presentation.

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See AAA Rule 30, supra note 31; NASD Code of Arbitration Procedure § 29; N.Y.S.E. Rule 616.


661. NASD Code of Arbitration Procedure § 37; N.Y.S.E. Rule 623. Note that the AAA does not require a record, but if one of the parties wanted it he could provide for it. See AAA Rule 23, supra note 31.


663. NASD Code of Arbitration Procedure § 30; N.Y.S.E. Rule 617. See supra text accompanying notes 628-37 for a brief discussion of fees.


665. Robbins, supra note 3, at 102.

666. See AAA Rule 32, supra note 31.

667. The AAA allows, but does not require witnesses to be sworn. AAA Rule 27, supra note 31. But NASD Code § 38 does require an oath or affirmation.


669. One of the major advantages of arbitration is that the arbitrators can use their industry expertise to draw out facts which the parties and their counsel may have ignored or overlooked.
of the case by both sides, and summations. It is always good practice for the arbitrators to ask at the close of the case if any party has additional evidence, and for each party to affirm that he or she has had a full opportunity to be heard.

In many arbitrations it will be advisable, or perhaps necessary, to use an expert witness. For the party who may need to present evidence using an expert, it is usually wise to have the expert involved in the case from the beginning. An expert can assist counsel by helping him evaluate the claim, as well as by indicating what information to seek in arbitration's limited discovery. Typically, an expert will be asked to testify as to technical matters, such as turnover ratios in churning cases, trading practices in cases dealing with improper executions, and evaluation of the risks of the investment and the customer’s financial acumen and ability to take risk in cases of suitability. The expert’s task is simple: to educate the arbitrators regarding a particularly technical aspect of the case.

It is often difficult to obtain an expert witness in normal litigation, and the same is true in arbitrations. Industry members are bound to appear if subpoenaed under exchange and NASD rules, but this will hardly produce a favorable climate for examination of an expert. In many cases before SRO arbitration panels, an arbitrator with industry expertise will serve a function similar to that of the expert witness. Consequently, there is less need for parties to introduce an expert to educate the panel. In fact, in many cases an industry panel member may have more expertise than an expert called to testify for one of the parties.

Another anomaly of the SRO process versus judicial proceedings and AAA arbitrations is the right of the panel to call its own witnesses. This can be done under the SRO rules without resort to subpoena under the power to direct appearance of any person employed by or associated with a member firm.

A hearing may be reopened prior to the rendering of an award, on the application of a party or by the arbitrators. Briefs may be submitted, but are advisable only in complicated cases.

670. This is one aspect of the arbitration which is unlike a judicial proceeding. The author has seen cases where the party or attorney was so inept at presenting the case that the panel in effect “took over” the questioning.

671. See AAA Rule 35, supra note 31.


674. AAA Rule 36, supra note 31; NASD Code of Arbitration Procedure § 40.

675. Robbins, supra note 3, at 106-07 which suggests that there is a need for briefs in (1) multi-session cases, where marshalling the facts presented may be
12. Deliberation and Award

The arbitrators are required to have read the pleadings before the hearing. They normally take extensive notes during the hearing. Because of their knowledge and expertise, arbitrators normally can understand the complexities and intricacies of a case. They will determine, as a finder of fact, the credibility of the witnesses and the weight to be given the evidence presented.

The award must be in writing and within the bounds of the law. Usually the award is based on unanimity, but the rules require only a majority. In most states, arbitrators can only award compensatory damages which include consequential damages and interest. Punitive damages are being sent to arbitration, and it is clear that statutory mandated punitive provisions, such as RICO, are arbitrable. Normally the award will assess the costs, filing fees, and if appropriate, interest. Under the AAA Rules and Uniform Code, arbitrators have 30 days after the conclusion of the hearing within which to render an award.

Previously, the award did not normally indicate anything other than the result reached by the arbitrators. The newly adopted SRO rules require the award to outline:

1. the names of the parties;
2. a summary of the issues in controversy;
3. the damages and/or other relief requested;
4. the damages and/or other relief granted;
5. a statement of other issues presented;
6. the number, dates, and locations of hearings; and
7. the names and signatures of the arbitrators.

necessary, and (2) to assist in bifurcated proceedings in determining the collateral estoppel effect of an award.

676. AAA Rule 42, supra note 31; NASD Code of Arbitration Procedure § 41.
680. AAA Rule 41, supra note 31; NASD Code of Arbitration Procedure § 41(d).
681. Under AAA Rule 42 there is a requirement that there be a statement regarding the disposition of any statutory claim. AAA Rule 42, supra note 31.
682. NASD Code of Arbitration Procedure § 41(e); N.Y.S.E. Rule 627(e). The AAA still encourages arbitrators not to give reasons for an award. See Coulson, supra note 34, at 694-97.
683. NASD Code of Arbitration Procedure § 41(e); N.Y.S.E. Rule 627(e). Under both NASD and NYSE rules the public parties can elect to omit their names, but the industry party can not.
Additionally, the awards are to be made public. Any party can request copies of all prior awards by arbitrators empaneled in their case.\textsuperscript{684} As a result of these new requirements regarding public disclosure of the issues decided, there is a possibility of more "precedent value" to the award than in the past.\textsuperscript{685}

The parties can apply for a judgment to be entered on the arbitration award, which will have the same force and effect as a judicial judgment.\textsuperscript{686} As noted above, \textit{res judicata} and collateral estoppel apply to arbitration awards.\textsuperscript{687}

13. Punitive Damages

Normally, an arbitrator would be presumed to have the power to award punitive damages, especially where so authorized by the provisions of the parties' agreement.\textsuperscript{688} The significance of an award of punitive damages as a part of an action is illustrated by the report of a South Dakota jury case which found against a broker for $200,000 in compensatory damages and $2.27 million in punitive damages.\textsuperscript{689}

In a 1976 New York case, however, the Court of Appeals held that arbitrators have no power to award punitive damages, even if agreed to by the parties. "The law does not and should not permit private persons to submit themselves to punitive sanctions of the order reserved to the State. The freedom of contract does not embrace the freedom to punish even by contract."\textsuperscript{690} The law is in a state of transition, however, as other states have taken an opposite position.\textsuperscript{691} Some courts

\textsuperscript{684} NASD Code of Arbitration Procedure § 41(f); N.Y.S.E. Rule 627(f). There are stringent time limits to this request: NASD has a three day rule after notification of panel composition; remember that there are only five days to exercise a preemptory challenge. See supra notes 594-99 and accompanying text for a discussion of preemptory challenges.

\textsuperscript{685} However, the NYSE Director of Arbitration has warned that arbitrators should not do so. See Robbins, supra note 34, at 27.


\textsuperscript{687} See supra note 476 and accompanying text regarding the finality of an award.

\textsuperscript{688} Annotation, \textit{Attorney’s Fees or Other Expenses of Litigation as Elements in Measuring Exemplary or Punitive Damages}, 30 A.L.R. 3d 1443 (1970).


\textsuperscript{690} Garrity v. Lyle Stuart, Inc., 40 N.Y.2d 354, 360, 386 N.Y.S.2d 831, 834, 353 N.E.2d 793, 797 (1976). This was a 4-3 decision upholding an award of treble damages under a trade association membership agreement providing for arbitration. See Lusardi, supra note 264, at 545-46 n.22, which refers to a colloquy between Justice Brennan and the attorney for the defendant during the oral argument in \textit{Byrd}, in which it was asserted that plaintiffs seek to avoid arbitration since arbitrators cannot award punitive damages under New York law. Sec. Reg. & L. Rep. (BNA) No. 48, at 1917 (Dec. 7, 1984).

\textsuperscript{691} See, e.g., Raytheon Co. v. Automated Business Sys., Inc., 882 F.2d 6 (1st Cir. 1989).
have held that when a case is governed by the federal Arbitration Act, punitive damages can be awarded. As noted above, many brokerage firms have a governing law provision in their customer's agreement using New York law. This ruling will have application in both state and federal courts. The typical claim will have both state and federal causes of action, and under Garrity state claims may have to be decided without the additional remedy permitted in a RICO-type federal action.

Of course, McMahon did expressly permit arbitrators to determine treble damages permitted under RICO, a federal punitive provision. In addition, Garrity was seemingly overruled by an unreported New York case which held that as a result of Southland Corporation v. Keating the Arbitration Act had created a substantive law of the United States, applicable under the commerce clause to both federal and state proceedings. Since Garrity had placed substantive limits on arbitrability, the District Court found Garrity to be overruled. Thus, arbitrators have the right under federal substantive law to find punitive damages even when applying New York law.

Under the recent Supreme Court decision in Volt Information Sciences, the choice of law provision of the parties contract governed arbitration procedures. This would seemingly give credence to the argument that New York law as exemplified by Garrity would prevail and arbitrators would not be able to award punitive damages. Duggal is distinguishable by the fact that it construed the federal provisions of the Arbitration Act in finding that punitive awards were within the arbitrator's purview.

Punitive damages are not available, however, under Rule 10b-5 claims, nor where state law will not permit them to be assessed. Therefore, it is normal to allege both state common law with federal securities claims in order to justify punitive damages.

A question arises if the contract can prohibit punitive damages.

692. See cases cited in Rath, supra note 470, at 797-98.
694. For a detailed discussion and citation of many state and federal cases see Krebsbach & Friedman, supra note 30, at 576-78.
698. See also Hirschman, supra note 29, at 1360-63.
This would seem inappropriate under the newly approved SRO rules which require predispute arbitration agreements to prohibit limiting or contradicting the rules or limiting both the ability of a party to file any claim or the ability of arbitrators to make any award. All clearly point to the ability of the arbitrators to award punitive damages in appropriate cases.\footnote{NASD Code of Arbitration Procedure § 21; N.Y.S.E. Rule 637.}

\section*{IX. Responses to McMahon and Rodriguez de Quijas}

Despite the decisions in McMahon and Rodriguez de Quijas, the question of the proper balance between the investor protection aspects of the securities laws and the congressional endorsement of predispute arbitration agreements remains. Which policy should prevail?

Several commentators have raised the question of whether the agreement to arbitrate is really freely made by investors. It is highly questionable whether investors who sign agreements with securities brokers are fully aware of the consequences of their agreements to arbitrate future disputes.\footnote{Wilko v. Swan, 346 U.S. 427 (1953).} Many agreements between investors and dealers are written on standardized forms which contain arbitration clauses rarely brought to the attention of the unsuspecting investor. Furthermore, there is rarely equality of bargaining power between the investor and the investment firm. This inequality is best explained by the greater frequency with which professionals, as compared to investors, enter into securities transactions. The investor, who transacts securities much less frequently, "is unlikely to pay much heed to matters as apparently trivial as arbitration clauses."\footnote{See Sterk, supra note 327, at 517-18.} Congress recognized this distinction between investors and brokers when it enacted the federal securities laws.\footnote{Malcolm & Segall, supra note 23, at 759.}

Of course this inequality of bargaining power and interest of the contracting parties is made even more acute by looking at the parties at the time they enter the relationship characterized by the brokerage account contract. The investor is, of course, not planning to have a dispute arise, nor should the broker, if both look to their economic interests. Both expect that the other will build a profitable relationship by reputable practices. But if either breaches that agreement, the resulting dispute—whether broker suing for the margin account balance of the investor, or the investor suing for some breach of duty of the broker—is only to be resolved by arbitration under most customer agreements. While Wilko recognized this concern, McMahon and Rodriguez de Quijas do not.

Clearly, the brokers now have the power in a relationship with typical customers to resolve any disputes through arbitration, as is evi-
denced by their unwillingness to deviate on a case-by-case basis from the standard printed forms. While this may be acceptable for intra-securities industry disputes—such as those between a brokerage house and employees or between brokerage houses themselves, where industry guidelines and a normative standard of conduct can be assumed—it does not lend itself to application in the typical customer relationship where there is little knowledge of these industry practices by the customer. To argue that the agreement is one-sided in these cases is axiomatic. Consequently, the question of informed consent should be the threshold. Otherwise, the customer should not be deemed to have knowingly assented to the arbitration forum rather than the resolution of disputes by the judicial process, as Congress apparently intended in the enactment of securities laws to protect the investor and the integrity of the marketplace. Neither the regulators nor the industry have been unaware of these concerns.

A. SRO Responses

Whereas prior to McMahon the NASD would take only cases where the customer agreed to submit, or there was a court order compelling arbitration, they presently will accept claims as long as they can determine the validity of the arbitration provision. Otherwise, a party must apply for such determination by the SRO or a court.

The Securities Industry Conference on Arbitration has revised the Uniform Code of Arbitration governing securities arbitrations, and the changes have been approved in large measure by the SEC. These rule changes are discussed in the following materials concerning the SEC responses and the May 1989 approval of SRO rule changes, but can be summarized as including changes in discovery; arbitration dis-

704. Id. at 760. A case-by-case approach to deciding if the arbitration clause was a product of inequality of bargaining power would be extremely time consuming and would require live testimony of both the broker and customer. Id.

705. 15 U.S.C. § 78f(a) (1982) ("as necessary or appropriate in the public interest or for the protection of investors . . . .").

706. Masucci, supra note 614, at 216-17. See also supra notes 87-93 and accompanying text for discussion of the issue of enforceability of the arbitration clause.


closure and classification; content and dissemination of awards; maintenance of a verbatim record; and pre-hearing conferences. The SROs are also revising educational pamphlets relating to disclosure of the arbitration process and are beginning to think about establishing special procedures for large and complex cases.

In keeping with the response of the SROs to this demand for adequate disclosure of the arbitration provisions in their customer agreements, the SICA developed a model rule in 1988 incorporating the disclosure requirements proposed in California. This rule requires that the arbitration clause be highlighted and that the customer acknowledge both the existence and explanation of predispute arbitration clauses. The SICA also prohibits any limitations or conditions on the customer's rights to arbitration.

The Securities Industry Association (SIA) developed a model customer predispute clause, which must be used or effectuated by members by September 7, 1989, in accordance with the SEC approval in May 1989 of the SRO rule changes. The Model Customer Agreement predispute clause provides:

Requirements Concerning Predispute Arbitration Agreements with Customers

Section 21(f)(1) No member shall execute an agreement with a customer containing a predispute arbitration clause unless such clause is highlighted and is immediately preceded by the following disclosure language (printed in outline form as set forth herein) which shall also be highlighted:

(i) Arbitration is final and binding on the parties.
(ii) The parties are waiving their right to seek remedies in court, including the right to jury trial.
(iii) Pre-arbitration discovery is generally more limited than and different from court proceeding.
(iv) The arbitrators' award is not required to include factual findings or legal reasoning and any party's right to appeal or to seek modification of ruling by the arbitrators is strictly limited.
(v) The panel of arbitrators will typically include a minority of arbitrators who were or are affiliated with the securities industry.

(2) Immediately preceding the signature line, there shall be a statement, which shall be highlighted, that the agreement contains a predispute
ment gives the customer the right to select a non-industry forum such as the AAA. Important provisions, such as the right to sell the customer out and the arbitration clause are in bold print, and there is an explanation of the difference between arbitration and court trials. The differences are set out as five points including that arbitration awards do not need to set out their factual or legal basis and are subject to very limited judicial review. The agreement is written in laymen's language.

One commentator noted that the clause constitutes about twenty percent of the entire suggested customer agreement, refers to all transactions arising out of stock and other property dealings of the parties, refers to the Arbitration Act, seemingly in reaction to Volt Information Services to limit application of state arbitration law, but also refers to the governing law of the contract. It also allows selection of either AAA or any SRO forum in accordance with the new rules prohibiting limitation on the ability to file any claim in arbitration, but seems to condition this election to those forums which are referred to in the rules of the SRO.

The SICA is also revising its explanatory materials on arbitration for investors.

Since Rodriguez de Quijas the SROs have been active in proposing a number of changes to the way arbitration works. Included in the proposed or accomplished changes are:

- Adoption of new rules by the SICA, which have been approved by the SEC.
- The SROs have adopted rules requiring disclosure concerning arbitration in the customer agreement, which must be used starting

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arbitration clause. The statement shall also indicate at what page and paragraph the arbitration clause is located.

(3) A copy of the agreement containing any such clause shall be given to the customer who shall acknowledge receipt thereof on the agreement or on a separate document.

(4) No agreement shall include any condition which limits or contradicts the rules of any self-regulatory organization or limits the ability of the arbitrators to make any award.

(5) The requirements of this subsection (f) shall apply only to new agreements signed by an existing or new customer of a member after [insert date].

Id. at 465. This clause does not appear in a separate writing, however.


718. See supra note 708.

719. Morris, supra note 8, at 230. See also text accompanying note 579.

720. See infra notes 761-75 and accompanying text.
September 7, 1989.\textsuperscript{721}

--- A requirement that members would make it clear to the customer that (a) arbitration is final and binding, (b) it is a waiver of otherwise existing rights to go to court, and (c) the right of appeal is very limited.\textsuperscript{722}

--- A new proposed rule which would prohibit the use of a clause which would limit the ability of a party to file an arbitration claim or the ability of the arbitrators to make an award.

--- A new Model Customer Agreement for margin customers has been developed by the SIA.\textsuperscript{723}

--- The CFTC has approved amendments to the National Futures Association Code of Arbitration establishing special procedures for disputes by U.S. customers against foreign firms.\textsuperscript{724}

--- The SICA has completed a guide for arbitrators, outlining the arbitrator's duty to avoid any appearance of bias through full disclosure, the arbitrator's ethical responsibilities, the procedure of a hearing under the Uniform Code, and role of arbitration staff.

In a related SRO rule change approval, the SEC acted on the request of the CBOE to change rules concerning service of pleadings, selection of arbitrators, disclosure of arbitrators' background, discovery and publication of award summaries similar to the changes previously approved for the NYSE, AMEX and NASD.\textsuperscript{725} Continuing its practice, the CBOE also requires highlighting of the arbitration provisions and requires explanation to customers of their rights vis-a-vis mandatory arbitration agreements.

In a related area, the National Futures Association has indicated concern that arbitration in the commodities area is being handled by non-commodity industry arbitral organizations, such as the NYSE, NASD and AAA. While the CFTC is given authority over arbitration, it does not supervise these SROs; the SEC supervises the SROs, and the AAA is not supervised.\textsuperscript{726}

B. National Association of Securities Act Administrators (NASAA)

On the same day that the SEC decided to table the staff recommendation prohibiting brokerage firms from denying access to the market


\textsuperscript{723} See supra note 714 and accompanying text.


\textsuperscript{725} 54 Fed. Reg. 32,731 (1989). The CBOE like the AMEX, permits public customers to exclude their names from the summaries of awards.

\textsuperscript{726} See Daily Report for Executives (BNA) No. 200, A-10 (Oct. 19, 1987). Of course, ultimately, SRO, AAA, and all arbitrations are subject to judicial review.
to investors who refuse to agree to predispute arbitration of disputes,727 the NASAA in a 1988 Briefing Paper, proposed the "top-to-bottom overhaul" of arbitration procedures728 which included just such a provision.729 The NASAA announced that it was exploring development of model language for state laws or rules to govern mandatory arbitration clauses in written customer agreements.730 The proposal was developed by a committee of the NASAA in response to McMahon and required not that arbitration be forbidden, but that a brochure explaining the terms and impact of arbitration be given to customers before a waiver would be enforceable. Meaningful disclosure was believed to be the way to avoid risk of "a new and chronic crisis in investor confidence if steps are not taken to make securities arbitration voluntary and fair to both the industry and investors. . . . Arbitration reform would send the right signal to investors who feel that the securities industry isn't concerned about the little guy."731

C. SEC Responses

Prior to McMahon, the Securities and Exchange Commission had taken the position that a predispute arbitration agreement with a customer was improper as a fraudulent, deceptive or manipulative prac-

727. See infra note 742 and accompanying text.

728. The "overhaul" included required formal training of arbitrators, fuller disclosure of arbitrators' backgrounds - including potential ties to the industry, disciplinary background of industry panelists and an annual updating of the brochure disclosing the alternatives of arbitration or litigation which would be given to customers.

The proposal also required arbitration agreements to be separate from other documentation of opening an account and proposed a definition of "public" versus "industry" arbitrators. Included in the "industry" definition was any person having ties including owing some part of their livelihood, to the industry (spouses, other family members, retired industry personnel, lawyers and accountants were specifically included).

Procedural improvements suggested included pre-hearing conferences, meaningful discovery at least 30 days in advance of a hearing with penalties for not disclosing documents, limited depositions, development of regional facilities for investor convenience, public disclosure of panel decisions, and the ability to award punitive damages, attorney's fees and pre-award interest. See infra note 747.


731. Daily Report for Executives, supra note 729 (remarks of Tennessee Director of Division of Securities and President of NASAA James Meyer).
After *McMahon*, the SEC rescinded this rule. From 1987 to May 1989, the SEC gathered information on the arbitration process. The SEC does check with the SROs to be sure that there are adequate resources to handle the caseloads without increasing backlogs.

However, since *McMahon*, the 1975 amendments to the Exchange Act, and the confidence the Supreme Court placed in the supervision of the industry by the SEC, the SEC has been active in supporting industry actions to improve the process even further than that the Court recognized to have taken place since *Wilko*. Because of this SEC supervision, several cases have found that claims of institutional bias raised by non-industry parties due to the predominantly industry-sponsored nature of the forums are not legitimate. Despite the SEC’s approval of the SICA 1989 changes in proceeding regarding arbitration as described below, a perception of bias still exists, especially in the minds of those who have presented a claim to industry-sponsored and subsidized panels and lost. This is, however, inherent in the adjudica-

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Of course, the customer agreements entered into between November 1983 and October 1987 will probably still contain the language prohibiting arbitration of securities law claims. Therefore, the chances of a pre-*McMahon* customer having waived his right to a judicial forum are somewhat less if the reference is to federal securities law claims, but if the language of the customer agreement indicated that all claims are arbitrable, “except as required by law,” there is a question as to whether the rescinded rule was a procedural notice rule or created substantive rights. *See* Neesemann, *Post-McMahon: The State of the Law*, in 601 SECURITIES ARBITRATION 1988, 153, 228 (D. Robbins. ed. 1988).


735. For example, the SEC conducted 21 inspections of SRO surveillance, compliance and operational programs in fiscal year 1988. *Id.* at 149.


My perception, and I believe the objective statistics bear me out, is that securities arbitrators approach arbitrations with the utmost good faith and try to resolve the disputes on the merits. Indeed, if biases or prejudices surface during the arbitrations, they usually work to the detriment of the industry litigant, not to its benefit. Industry representatives are harsh critics of their competitors, and are very conscious of the public’s perception of the securities industry. They do not hesitate to enter substantial awards against industry litigants.

*Id.* at 360.

737. *See infra* notes 761-75 and accompanying text.
tion of disputes—if it were a court, a party could conceivably feel the judge was “bought out” by the other side despite a completely fair trial and decision on the merits.

The SEC has not taken a public position on mandatory arbitration since rescision of Rule 15c2-2 and its amicus brief in support of arbitration in McMahon.

1. The Staff Recommendations

The SEC staff recommended banning mandatory predispute arbitration agreements in a 1987 report, but the Commission did not adopt the recommendation, preferring instead to give the SROs an opportunity to comment and adjust their rules regarding membership conduct.738

The SEC Division of Market Regulation did ask the SEC to send a letter to SICA members asking them to adopt regulations prohibiting their members from making predispute arbitration agreements mandatory. After reporting the result of the survey of 65 firms concerning arbitration as a precondition to doing business,739 the staff noted that customers in many cases are given no flexibility on the signing of such agreements. In many ways, since most brokerage firms refuse to open an account without such a clause, the contract of adhesion argument again rears its head. If the industry is truly affected with a public interest or public trust, it would seem that refusal of the firms to allow retail customers to waive this provision becomes suspect. The argument becomes further attenuated as a result of the firms waiving the predispute agreement to arbitrate disputes for institutional investors.740 It does seem that bargaining strength is definitely a consideration in the decision of broker-dealers to allow some customers to do business without such arbitration agreements, but not the private, small investor. After all, it is the small, unsophisticated investor who the securities laws were designed to protect and it is their participation in the securities marketplace which these laws seek to encourage.741

The SEC response to the staff recommendations varied, but the Commission tabled the proposal June 1, 1988 and then reopened it July


740. See Daily Report for Executives, supra note 729.

1. Commissioners Cox and Grundfest questioned the staff involvement with the SICA, recommending additional effort to have the SROs consider rule amendments and that the industry be able to "present its case" before SEC action would be appropriate. Despite staff rationale of why a person would not sign such an agreement, the SEC concluded that SEC action banning predispute arbitration agreements was premature without more industry involvement. Chairman David Ruder reached the crux of the argument, however, in stating, "I fail to see why one should be denied access to the securities markets if they want to waive signing an agreement. That's unfair to small investors."

Since this consideration of the regulation of the disclosure of broker-customer predispute arbitration agreements, the SROs have responded and the SIA has prepared a new form of customer agreement which makes the predispute arbitration clause more conspicuous, as well as new brochures more fully disclosing the customer's options as far as litigation versus arbitration are concerned. The SIA has not, however, gone so far as to reverse the broker's duty to explain the meaning of a predispute arbitration clause.

2. The SEC's Letters to SICA Members

In November 1987 the SEC wrote SICA members regarding a staff proposed award statement. It would (1) name the parties, (2) give a one paragraph summary of the dispute, (3) state the damages or relief requested, (4) state the damages or relief granted, (5) give a one paragraph summary of issues resolved, and (6) name the arbitrators.

In September 1987 the SEC Director of Market Regulation, Richard Ketchum, wrote all SICA members suggesting that as part of the SEC's oversight it felt certain areas of the arbitration process needed improvements in order to assure the procedural fairness of SRO-sponsored arbitrations. Fifteen specific improvements were suggested.

742. The greater pretrial discovery process, a judiciary which is more independent of the industry than the general perception indicates regarding arbitration panels, and the ability to appeal all would lead a customer to decide to litigate rather than submit to arbitration. The staff further indicated that the real question is one of disclosure of alternatives to the customer, since many rely on the advice of their retail broker in opening an account. See Daily Report for Executives, supra note 729.

Chairman Ruder also indicated that he felt "customer choice, at least in cash accounts, will be maintained" and that there should be sufficient notice given to investors that they will be bound by a predispute arbitration clause. Moulin, supra note 41, at 449, 451.


744. See supra note 714 and accompanying text.


746. This one page award statement was used prior to the May 1989 SRO rule changes. See Rath, supra note 470, at 798.

747. The SEC asked the SICA to consider (1) revising standards for arbitrator
all of which have been addressed either by the May 19, 1989 SRO arbitration rule changes or are being considered by the SICA at this time.\(^{748}\)

In September 1988 the SEC wrote to SICA members again with suggestions as to how the arbitration process could be further improved.\(^{749}\) Chairman Ruder in July 1988 also requested SROs to report back to the Commission after "review of the issues raised by the current use of mandatory predispute arbitration agreements."\(^{750}\)

However, neither the SEC nor the industry has focused on the number of remaining problems. First, most customers are shocked to discover only when a dispute has arisen that they have signed standard agreements which give away their rights to a jury trial and even a judicial process. A suggestion has been made to provide a short disclosure statement that explains arbitration and asks the customer to sign a separate consent, permitting rejection of the arbitration clause if that is the customer's informed desire.\(^{751}\) If the reason for arbitration clauses is economic, then the customer should be informed that his choice not to arbitrate any later arising disputes will carry with it a higher commission fee or service charge to pay for the higher costs of litigation.\(^{752}\)


\(^{749}\) See Fitterman, McGuire & Love, supra note 27, at 185-86 for a copy of a letter sent by David S. Ruder, SEC Chairman, to all SROs dated July 8, 1988.

\(^{750}\) Id.

\(^{751}\) See Shell, Arbitration After the Crash, Nat'l L. J., Mar. 21, 1988, at 13-14, col. 1. This is similar to the CFTC position and the new SICA model agreement. See also supra notes 9 and 714 and accompanying text.

\(^{752}\) Shell, supra note 751, at 14. Of course, with the imposition of higher charges there are likely two economic results. First, the customer will sign the arbitration clause knowingly, wanting to keep his transaction costs as low as possible and certainly no one goes into a brokerage contract with the anticipation of having a dispute arise. Second, unless all firms adopt similar pricing policies, or adjust their rates to reflect these higher costs, the competitive advantage will rest with the firms which do not adopt two-tier pricing of services rendered to customers.
Chairman Ruder has indicated SEC opposition to legislation prohibiting mandatory arbitration on the grounds that (1) "the securities industry would provide 'a more imaginative solution,'"753 (2) the SEC has received reports that the industry is reversing the trend requiring arbitration clauses in cash accounts,754 and (3) SEC oversight would be limited by any legislative required procedure affecting the flexible evolution of an appropriate system.755 Ruder also suggested that complex cases should be referred to the courts for resolution. These would include class actions, multiple parties, and those cases involving novel legal theories or challenges to established industry practices.756

Remember that four dissenting Justices in McMahon believed that arbitration still had an image problem stating that "because of the background of the arbitrators, the investor has the impression, frequently justified, that his claims are being judged by a forum composed of individuals sympathetic to the securities industry and not drawn from the public."757 The identity of arbitration panels of some organizations was not subject to public inspection, as it is not a public record.758 In light of this perceived problem with fairness of the process, the SEC has begun the process of instituting reform within the SROs.759 But the SEC has not specifically addressed these questions to date.

Other problems in the post-McMahon and Rodriguez de Quijas era are adequate resources for the industry arbitration forums. All are now being strained to the limit in terms of caseloads and merely keeping abreast of the burgeoning numbers of new filings. The SEC is particularly concerned with training and evaluation of arbitrators. The composition and token fees paid to arbitrators also create a question regarding the competence and impartiality of panels.760

754. Moulin, supra note 41, at 449. Chairman Ruder felt that the use of arbitration clauses in cash accounts was "particularly disturbing" and that "customer choice, at least in cash accounts, will be maintained." Id.
755. Id. at 453.
756. Id. at 452. The SICA is also considering special procedures for these cases. Id.
758. See Cole, Prudhoe Comes Under Fire for Alleged Improperities, Los Angeles Bus. J., Aug. 1, 1988, § 1, at 1 (NASD refused to reveal names of arbitrators in Southern California). But see SRO rule changes, including discussion of awards, text accompanying infra notes 761-75.
759. See Labaton, Broker Cases: New Rules, N.Y. Times, Sept. 21, 1987, at D2, col. 1. This article was, of course, before McMahon and Black Monday.
760. Id. Labaton suggests that a better procedure would be for the panels to be selected by the customer from a list of possible arbitrators supplied by the industry-subsidized SRO arbitration staff, similar to the AAA procedure. He suggests SEC
3. SEC Approves SRO Arbitration Rule Changes

In Release No. 34-26805,\textsuperscript{761} the SEC approved the SRO rule changes regarding arbitration procedures. These rule changes were directly a result of the SEC inquiries into industry arbitration practices and procedures and the concerns discussed above, and reflected comments on the proposed rules from many groups. Specifically, the rule changes approved dealt with the following areas:

Service of Pleadings. Under present practice, delay has resulted from the service of pleadings coming through the arbitration departments of the SROs. Under the new rules, the arbitration departments will only serve the initial claim and all subsequent pleadings are served directly on the other party.

Classification of Arbitrators. While all arbitrators are required to be impartial, the appearance of neutrality should be improved by new rules regarding persons associated with the industry and those who are classified as "public" arbitrators. While the SRO rules vary slightly,\textsuperscript{762} the SEC recognized that the presence of knowledgeable industry panelists including lawyers, accountants and other professionals who may be either classified as industry or public arbitrators is necessary.

Arbitrator Disclosure. Like the AAA Code of Ethics,\textsuperscript{763} the SROs have now developed rules\textsuperscript{764} which require that arbitrators disclose any existing or past financial, business, professional, family, employment, associate,\textsuperscript{765} or social relationships that are likely to affect impartiality or create the impression of bias or partiality. The rules extend to relationships with the parties or counsel, and even witnesses. The arbitrator's duty to disclose is a continuing one. To assist the parties in determining if panels are properly balanced between industry and public arbitrators, ten year employment histories are also to be provided.\textsuperscript{766}

In addition, the Uniform Code provisions were adopted regarding informing the parties of the business affiliations of the arbitrators eight

\textsuperscript{761} See supra note 708.
\textsuperscript{762} NYSE Rule 607 defines industry arbitrators to include any person who has been employed for (a) a "substantial" part of his or her career and (b) within the last five years; NASD Code § 19 and AMEX Rule 602 adopt the Uniform Code standard that an industry panelist has not been employed for the last three years.
\textsuperscript{763} Code of Ethics for Arbitration in Commercial Disputes (AAA pamphlet 1977).
\textsuperscript{764} See, e.g., N.Y.S.E. Rule 610.
\textsuperscript{765} A professional who devotes twenty percent or more of his or her work-effort to securities industry clients in the last two years is considered an industry arbitrator.
\textsuperscript{766} N.Y.S.E. Rule 608; Am. Stock Ex. Rule 603; NASD Code of Arbitration Procedure § 21.
days prior to the hearing with the right to additional information.\textsuperscript{767} This ties to the right of the parties to also request all prior awards of the arbitrators.\textsuperscript{768}

\textit{Replacement Arbitrators}. Under present rules, a vacancy will permit the parties to decide to continue with a replacement arbitrator or begin the hearing process anew, unless the parties are given eight days notice. The new rules will permit appointment of a replacement in less than eight days and allow the parties to decide to continue with the remaining arbitrators in the event of a vacancy after the hearing has commenced.\textsuperscript{769}

\textit{Small Claims Procedures; Number of Arbitrators}. The simplified procedures for small claims with only one arbitrator would be applicable to a $10,000 claim, up from the previous $5,000 limit.\textsuperscript{770} The number of arbitrators in large cases would be three rather than five.

\textit{Discovery}. As noted above,\textsuperscript{771} pre-hearing discovery has been of concern to the SEC. The new rules permit such discovery, although not to the same extent as litigation might.

\textit{Record and Content of Awards}. The new rules also provide for the stenographic or tape recording of hearings for the preservation of a record,\textsuperscript{772} and for the award to be more complete than the mere statement of result.\textsuperscript{773} Both will assist review of the arbitrators' decision-making.

\textit{Fees}. Rule changes permitting significant fee increases to be assessed by the arbitrators were also approved.\textsuperscript{774} The SEC felt the increases appropriate since they were not mandated but rather left to the arbitrators to determine.

\textit{Predispute Arbitration Clauses}. The Commission approved rule changes relating to the SIA and SICA model arbitration clauses discussed above.\textsuperscript{775} It did not adopt suggestions that the clauses be separately initialled or on a separate page.

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{767} See N.Y.S.E. Rule 608.
\item \textsuperscript{768} See supra note 626 and accompanying text.
\item \textsuperscript{769} See N.Y.S.E. Rule 611; Am. Stock Ex. Rule 602; NASD Code of Arbitration Procedure § 24.
\item \textsuperscript{770} Am. Stock Ex. Rule 621; NASD Code of Arbitration Procedure § 13. Both rules and the NYSE practice appoint a public arbitrator to determine these small claims. NASD Code § 9(a) would also permit one arbitrator to hear claims of $30,000 or less.
\item \textsuperscript{771} See supra note 642 and accompanying text.
\item \textsuperscript{772} See supra note 661 and accompanying text.
\item \textsuperscript{773} See supra notes 681-82 and accompanying text.
\item \textsuperscript{774} See supra note 633.
\item \textsuperscript{775} See supra notes 714-18 and accompanying text. Note that the new form for predispute arbitration clause ties into the rules relating to the availability of arbitration to customers. See N.Y.S.E. Rule 637; Am. Stock Ex. Rule 427; NASD Code of Arbitration Procedure § 21.
\end{itemize}
\end{footnotesize}
D. Congressional and State Responses

The McMahon and Rodriguez de Quijas decisions permitting enforcement of arbitration clauses in the securities industry has elicited responses from Congress, state legislatures and state regulators.

1. Congress

Congressman Edward J. Markey (D-Mass.) introduced legislation in the 100th Congress in 1988 to prohibit mandatory arbitration in securities investor accounts.\(^{776}\) Congressional action has to some extent been stalled due to the uncertainty over whether the SEC would come out in favor of or against mandatory arbitration clauses in investor-broker account agreements. But it can be expected that additional hearings will take place in the 101st Congress on this issue, as the 100th Congress adjourned without taking any action on this matter.\(^{777}\)

Markey noted in his remarks that only after Black Monday did investors realize they had signed arbitration agreements with brokers. "Confronted with abuses of discretion, misexecution of orders, and other wrongs committed against them, they were shocked to learn they had no recourse to the courts of law. Instead of being able to elect arbitration as part of a rational decision after the claim had arisen, they were compelled to [arbitrate]."\(^{778}\) Markey felt that the right of investors to choose judicial resolution of future disputes is a "basic investor protection" needed to restore investor confidence in the marketplace and industry after Black Monday.\(^{779}\) The brokerage business is regulated because it is both a public trust and public franchise, therefore the firms should not have the complete freedom to do business as they choose, and should not be able to impose "upon their customers these contracts of adhesion."\(^{780}\)

Immediately following the Rodriguez de Quijas decision, Representative Markey characterized the decision as a "blow to the rights of the small investor" and observed investors should not have to make a

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\(^{776}\) See Eppenstein, supra note 412, at 111-17. See also Moulin, supra note 41, at 433-34 (opening statement of Hon. Edward J. Markey (July 12, 1988)); 143 Cong. Rec. E2233 (daily ed. June 30, 1988) (statement of Congressman Boucher); id. at E2233-41 (statement of Congressman Dingell); id. at E2245-46 (statement of Congressman Markey, including an analysis of the proposed legislation, the Securities Arbitration Reform Act of 1988, which would make arbitration optional in opening an account; reform panels and procedures of the securities arbitration SRO facilities to make the process more fair, at least in appearance; and require written reasons for an award). This legislation died in Committee at the end of the last Congress. 2 Cong. Index (CCH) 35,206.

\(^{777}\) 2 Cong. Index (CCH) 35,106. See also Knight, Drive Targets Mandatory Arbitration, Washington Post, Sept. 22, 1988, at E1, col. 5.


\(^{779}\) Id. at E2245.

\(^{780}\) Id.
“Faustian bargain of signing away rights to litigate in order to invest in our financial markets.”

Congressman Dingell, chairman of the House Subcommittee on Oversight and Investigations, felt a more pressing concern with “complaints that arbitration procedures are rife with conflicts of interest since the arbitrators are peers of the brokerage firm being sued.” This contention is supported by the fact that sometimes a customer will sue the clearing agency, which is both owned and operated by the same exchange which offers arbitration. Again, the independence of the forum from the parties to the dispute is a question of perceived fairness.

These congressional responses were opposed by active lobbying by the securities industry. The SEC and consumer protection groups, including the NASAA, were supportive, but their lobbying effort was not extensive. Of course, these proposals have been largely adopted in the SRO rule changes approved by the SEC as discussed above.

2. State Responses

State regulation of arbitration still exists. As noted above, common law and state law relating to the formation, validity, revocability and enforceability of the underlying agreement also affect the question of submission to arbitration. State law can also affect the requirement that the award be enforced. These state impacts on the arbitration process are permissible so long as they apply to contracts generally. The regulation is not permitted if it singles out arbitration agreements for special treatment.

Three states, Massachusetts, California, and New Mexico were reported to be considering the prohibition of use of mandatory predis-
pute arbitration agreements in June 1988.\textsuperscript{788} Wisconsin considered adoption of a "Massachusetts Rule," but decided against it.\textsuperscript{789} Montana held hearings in November 1988, and New Jersey\textsuperscript{790} and Maryland\textsuperscript{791} debated a "Massachusetts Rule" bill, but no state has adopted legislation or regulations to date. Sixteen states were considering adoption of some kind of uniform legislation proposed by the NASAA.\textsuperscript{792}

3. Massachusetts Regulations: Declared Invalid

The Massachusetts regulation was adopted by the Secretary of State of the Commonwealth on September 21, 1988 through his authority under the Massachusetts Uniform Securities Act.\textsuperscript{793} The regulation prohibited, as a dishonest or unethical practice in the securities business, the requirement that a broker-dealer impose on Massachusetts investors a mandatory predispute arbitration contract as a non-negotiable precondition for doing business with the broker. It further requires that if a broker wishes to have a mandatory predispute clause after January 1, 1989, the contract must "conspicuously disclose" that executing such an agreement is not a condition to opening a brokerage account, and if such a provision is included, the broker must fully disclose the legal effect of the predispute arbitration contract or clause in writing to the customer.\textsuperscript{794}

Violation of this regulation is contrary to standards of commercial honor and just and equitable principles of the trade in the conduct of the brokerage business, and as such is grounds for denial, suspension or revocation of registration of the broker-dealer or such other action as provided by the Massachusetts Uniform Securities Act.\textsuperscript{795} Of course, in order to do business in Massachusetts a broker must be registered.\textsuperscript{796}

If effective, the Massachusetts regulation would have prohibited a brokerage firm from requiring mandatory predispute arbitration agreements from investors in opening accounts. The regulation, while not

\textsuperscript{788} See Daily Report for Executives, \textit{supra} note 729, discussing the NASAA proposals for an "overhaul" of the arbitration procedures and disclosure through a brochure of the advantages and disadvantages of arbitration \textit{vis-a-vis} litigation for resolution of disputes. \textit{See also infra} note 833 and accompanying text.

\textsuperscript{789} Moulin, \textit{supra} note 41, at 321. The "Massachusetts Rule" refers to the regulations with which the Connolly case was concerned.

\textsuperscript{790} \textit{Id.}

\textsuperscript{791} \textit{Id.} at 480-83.

\textsuperscript{792} See Moulin, \textit{supra} note 41, at 315-18, 321 for more detail on state legislative efforts in this area in California, Massachusetts, Wisconsin, Montana, New Jersey and Maryland.


\textsuperscript{796} \textit{Id.} § 201.
prohibiting such arbitration agreements, required not only that advice be given to customers that arbitration might affect their legal rights, but also that such information be conspicuous and part of negotiations with customers. How the broker was to define the terms “conspicuously disclosed” and “negotiation” was not specified. As noted above, one broker uses red ink. There is no indication whether this would meet the requirement of the regulation. Further, the nature of the “disclosure” is vague. No standard is given for a broker-dealer to meet in the regulation, with the result that the regulation was probably also invalid for lack of specificity. The regulators indicated that “[w]e don’t necessarily have a beef with the arbitration process. . . . We just think the consumers ought to have a choice.” They indicated the regulation was designed to “protect small investors who have been forced by the vastly superior economic power of their brokers to accept an arbitration clause” in contracts opening brokerage accounts.

The regulation was immediately attacked by the Securities Industry Association and ten member firms as unconstitutional, since it required that arbitration agreements be treated differently from other contracts, which is impermissible under the Federal Arbitration Act. The United States District Court for the District of Massachusetts found in Securities Industry Association v. Connolly that the Massachusetts Blue Sky officials were without power to adopt the regulations and granted plaintiffs’ motion for summary judgment. This decision was based on the preemption doctrine. Judge Woodlock determined that the Massachusetts regulations were not merely state law supplementation collateral to the validity and enforceability of arbitration agreements, but went to the heart of the process of arbitration. Accordingly, he found that the regulations singled out arbitration agreements “for more demanding standards than are imposed by the general law of con-

798. See id. at 158-60. The court noted that the Massachusetts regulation was significantly less precise than the CFTC regulations, for example, the CFTC regulations do not permit a predispute arbitration agreement to be a condition of opening an account whereas Massachusetts only requires disclosure and notice and would permit the firms to condition opening an account on execution of the arbitration contract. Id. at 157 n.17.
801. The SIA’s members are brokerage firms. This was the same association which filed amicus briefs in Byrd and McMahon.
803. Id. at 161.
804. Id. at 147.
tracts in Massachusetts." He concluded that because of the plaintiffs' clear likelihood of ultimate success on the merits of their preemption claim, the prospect of substantial irreparable harm to the plaintiffs if the injunction is not granted—as balanced against the potential for minimal harm to the defendants if the injunction is granted—and the public interest on the part of both customers as a class and the public at large in furthering the emphatic national policy in favor of the efficiencies of arbitral dispute resolution, an interim injunction staying implementation of the . . . regulations . . . would be appropriate.

The court did not have to question the ambiguities in the regulation regarding negotiability and conspicuous disclosure. The regulations would have had the effect of changing the practice of the brokerage industry, insofar as brokers almost uniformly used contracts with predispute arbitration agreements. Finding that the Arbitration Act preempted the Massachusetts regulation, the court examined the federal preemption doctrine and found that the regulation did "disturb the federal arbitration scheme" of Congress, which "policy has been set loose with hydraulic pressure, sweeping away any state law purporting to 'override the parties' choice to arbitrate rather than litigate in court.'

In effect the court found that the Arbitration Act did not permit states to limit the use of arbitration. The "formation of arbitration contract can be wholly a matter of state law 'if that law arose to govern issues concerning the validity, revocability, and enforceability of contracts generally.'" Since the regulation only applied to arbitration agreements, these contracts were on a different footing, were a radical departure from the way other contracts were treated, and were not merely collateral to the arbitration agreement, all of which are impermissible under the Arbitration Act.

805. Id.
806. Id. at 160.
807. In fact, the court reviewed the plaintiff firms and found that all used arbitration in standard margin and option account contracts (with one exception); a bare majority do not use arbitration in cash account contracts for individuals (one did use a clause in corporate cash account contracts); and only one firm indicated that execution of the arbitration agreement is not a requirement for opening a cash account. Id. at 149-50.
808. See id. at 150-51 and cases cited therein.
809. See id. at 151 (quoting New England Energy, Inc., v. Keystone Shipping Co., 855 F.2d 1 (1st Cir. 1988)).
810. Id. (citing Perry v. Thomas, 482 U.S. 483, 492 n.9 (1987) (emphasis in original)).
811. Id. at 153.
812. See id. at 152. The defendants, the regulators, had conceded this point. Id. The defendants had justified the regulations by relying on the fact that brokers would not deal with customers who did not agree to the arbitration provision. The Court found that "Massachusetts is not free . . . to develop a definition of
Since the court analogized the regulation to the federal\textsuperscript{815} and Massachusetts\textsuperscript{814} truth-in-lending legislation, there may be a loophole for state regulators. The Massachusetts truth-in-lending law represented a significant departure from law which affects contracts generally, but it did not single out arbitration agreements. Consequently, a statute which is concerned with the voluntariness of contracts could address arbitration by forbidding the waiver of the right to litigate all such agreements without knowledge and express consent. Therefore, state legislators can avoid preemption by creating a law which applies to contracts generally, but covers only the question of arbitration.

Although section VI appears to be merely an addendum, it does enjoin enforcement of the Massachusetts regulation as being preempted by the Arbitration Act.\textsuperscript{815} The court indicates a reticence to interfere with state economic regulations. However, the court found legislative intent that Congress and the SEC should supervise securities arbitration.\textsuperscript{816} As the Supreme Court indicated in \textit{McMahon}, any modification of the position regarding the Arbitration Act's application to the securities industry must come from Congress. "Until Congress establishes exceptions to the [Arbitration Act] permitting states to adopt singular legal principles for the formation and execution of arbitration agreements, state law provisions like the Massachusetts . . . regulations cannot stand."\textsuperscript{817}

The defendants had also argued that the clauses in the federal securities laws, expressly saving Blue Sky law,\textsuperscript{818} as a justification to permit the regulation. The court found that the savings provisions "do not provide a 'contrary Congressional command' permitting state . . . regulators to establish special conditions applicable to arbitration contracts in derogation of the directions of the [Arbitration Act]."\textsuperscript{819} The court

\footnotesize{voluntariness applicable only to the negotiation of arbitration . . . and not to other contracts generally." \textit{Id.}}


\textsuperscript{815.} The opinion up to part VI addresses the issue of preliminary injunction, forbidding enforcement of the regulation which was to take effect on January 1, 1989 until a full hearing on the merits. \textit{Connolly}, 703 F. Supp. at 156-60. Part VI, however, grants the defendant's motion seemingly as an afterthought to the preliminary injunction opinion. \textit{Id.} at 160-61. However, the result is clear: Massachusetts cannot develop a definition of voluntariness applicable only to the negotiation of arbitration agreements and not to other contracts generally. \textit{Id.} at 161.

\textsuperscript{816.} See supra note 249.

\textsuperscript{817.} \textit{Connolly}, 703 F. Supp. at 161. Judge Woodlock states in the final paragraph of his opinion that this result is because the regulations do not apply to contracts generally, but just to arbitration agreements.

\textsuperscript{818.} \textit{Id.} at 154.

\textsuperscript{819.} \textit{Id.} (citation omitted). The court's discussion of congressional enactment of Blue Sky Law in the District of Columbia is of interest. In Levin v. Dean Witter Reynolds, Inc., 3 Blue Sky L. Rep. (CCH) ¶ 71,812 (D. D.C. 1983), the
asked the SEC to file an amicus brief. The SEC refused, stating that the underlying claim was based on the Arbitration Act rather than the securities laws.\textsuperscript{820}

The First Circuit affirmed the Connolly decision.\textsuperscript{821} The court reasoned that (1) while Congress did not intend the Federal Arbitration Act to occupy the entire field of arbitration law, the courts "must receive the act hospitably and defend its mechanisms vigilantly;"\textsuperscript{822} (2) while state regulation of contracts is necessary, "Congress barred the states from making determinations about arbitration contracts"\textsuperscript{823} in certain areas, especially arbitration;\textsuperscript{824} and (3) the arbitration clauses serve a useful economic function. They permit brokers to employ standardized, form contracts, and to forbid arbitration clauses will "undercut the policies of simplicity and expedition that characterize the arbitral alternative."\textsuperscript{825}

In Saturn Distribution Corporation v. Williams,\textsuperscript{826} the Eastern District of Virginia found that it would be permissible for the state to allow car dealers to drop a mandatory arbitration provision in a dealership agreement. The Motor Vehicle Commissioner refused to permit the exclusive arbitration clause, but did allow an agreement which would provide the dealer an option to delete the arbitration clause.\textsuperscript{827} The court found that "in order to be legitimate, [arbitration] must result from acquiescence of both parties; it may not be imposed by one party on the other."\textsuperscript{828} The court distinguished Connolly, finding its holding "restrictive," even though the regulation there applied only to arbitra-

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\textsuperscript{820} Connolly, 703 F. Supp. at 155 n.16. The court indicated that the SEC's reason appeared less than candid in light of the defendant's reliance on federal securities law for its opposition to the motion for summary judgment. I recognize, however, that various prudential and strategic considerations, including an interest in permitting the case law to ripen and a desire not to become committed even indirectly on an issue as yet unresolved within the agency, may govern the decision.

\textsuperscript{821} Securities Indus. Ass'n v. Connolly, 883 F.2d 1114 (1st Cir. 1989).
\textsuperscript{822} \textit{Id.} at 1119.
\textsuperscript{823} \textit{Id.} at 1120 (citations omitted).
\textsuperscript{824} \textit{Id.} "[The state] may not say (judicially, legislatively or in a regulatory mode) that 'adhesion contracts are especially bad when arbitration is included,' so we will therefore ban, or place gyves and shackles upon, only those adhesive contracts which contain arbitration clauses." \textit{Id.} at 1121.
\textsuperscript{825} \textit{Id.} at 1124.
\textsuperscript{827} \textit{Id.}
\textsuperscript{828} \textit{Id.}
tion and in Saturn arbitration was not singled out. 829

4. Other State Regulations and Legislation

This Massachusetts approach was the beginning of a coordinated effort to regulate predispute arbitration securities contracts by the North American Securities Administrators Association, an association of the state securities regulators. 830 Approximately sixteen states gave power to the securities administrator similar to the power given to the Secretary of State in Massachusetts. 831 In other states, legislation would be required to grant rulemaking authority in the administrator. 832

After the Massachusetts regulation was adopted, a survey of the securities regulators indicated that more than a dozen of the states whose regulators are members of the North American Securities Administrators Association were expected to consider rules which would ban forced arbitration of investor disputes. 833 New Jersey is reported to be the first state to consider legislation to ban firms from requiring the use of arbitration. 834 New Mexico’s Securities Commissioner was reported to have considered adopting similar legislation, but then deferred the implementation of regulations limiting the use of arbitration clauses. 835

In 1988, California considered adopting legislation regarding disclosure and the optional nature of an arbitration agreement. 836 These proposals, while not yet adopted, have nevertheless provided a method for industry reform. 837

Reasons vary for the state regulators’ opposition to mandatory predispute arbitration in securities cases. A major issue is that McMahon did not say that arbitration was required, nor did McMahon say that arbitration is something upon which investors should agree. It did, however, clearly say that brokers could require customers to use arbitration. If the securities administrators are correct that panels of arbitrators are stacked in favor of the industry, because of the absence of written decisions, public hearings, and normally a lack of ability to appeal to a court, then the regulators should step in and regulate the practices of the industry.

It is clear, however, that state regulation, legislative or administra-

829. Id.
830. See Knight, Drive Targets Mandatory Arbitration, Washington Post, Sept. 22, 1988, at E1, col. 5.
831. Id.
832. See supra notes 789-92 and accompanying text.
833. See Massachusetts Says Brokers Can’t Insist on Arbitration, Wall St. J., Sept. 22, 1988, at 41, col. 5; supra note 731. See also supra note 792 and accompanying text.
835. Rath, supra note 470, at 811.
836. See Moulin, supra note 41, at 316-18.
837. Id.
tive, can be supported, provided it is not only directed to securities arbitration. As long as the restriction applies to all contracts, they will be enforceable.

5. State Judicial Approaches

State courts have given deference to the interpretation of the federal courts when state and federal securities law provisions are similar. The same public policy drives the regulatory scheme for both. As a result of Wilko, it can be anticipated that the state courts which have previously followed federal interpretation will have a problem with the dramatic shift in McMahon and Rodriguez de Quijas. Consequently, it may be wise for a litigant to plead, if possible, state violations rather than federal claims to avoid mandatory arbitration.

Prior to 1977, the Colorado Court of Appeals had not examined whether arbitration clauses were enforceable with respect to claims arising under the Colorado Securities Act. A 1980 article pointed out that the Colorado statute had a provision virtually identical to section 14 of the Exchange Act. Federal interpretation has been held persuasive for Colorado courts considering similar provisions to the securities laws. There is also caselaw favoring arbitration. In 1980, the court expressly adopted the Wilko rationale, finding an attempt to stipulate was to waive compliance with the Colorado Securities Act and therefore void.

E. Sanctions for Not Using Arbitration

In keeping with the law's preference for arbitration, the courts are applying sanctions against parties who attempt to avoid legitimate arbitration of disputes. For example, in a recent case, the Seventh Circuit imposed Federal Rule of Civil Procedure 11 sanctions on a brokerage firm for trying to evade arbitration by litigating in the courts. Brokers will not be permitted to, on the one hand, force arbitration on its

843. See Paine Webber, Inc. v. Farnam, 843 F.2d 1050 (7th Cir. 1988). The Court observed: "The securities industry insists that its customer sign arbitration agreements, which the Supreme Court has sustained in part on the premise that it is desirable to have a cheap, quick method to deal with the disputes (many too small to justify full scale litigation) this industry produces." Id. at 1052. See also Herzl & Harris, An Ambiguous Victory for the Small Brokerage Client, Financial Times, June 30, 1988, § I, at 9, col. 1.
customers, and on the other, choose litigation when it might be possible to wear down the customer through delays or costs.

In one case, the attorneys for the brokerage firm did not make a reasonable inquiry into the possibility that the broker had forged the customer agreement and nevertheless filed a motion to stay proceedings based on the arbitration clause. The court reserved its right to determine sanctions under Rule 11, but "suggested" to the brokerage firm and its attorneys that "further failure to comply with Rule 11 will not be tolerated. Thus, ... defendants should only proceed ... on the issue of forgery as their position is 'well grounded in fact.'" In another case, an attorney for customers was personally sanctioned in an amount of $1,000 for misinterpreting a federal judge's stipulated order directing arbitration.

If a party has received an award in arbitration and successfully raises the award as collateral estoppel, that party may be entitled to attorney's fees and expenses pursuant to Rule 11. These sanctions are imposed due to the inception of a lawsuit; other sanctions can be imposed if an improper appeal is brought.

F. Tort Action on Arbitration Award

In a novel case, two investors sought $608,000 damages from the CBOE for mental anguish and the expense of defending an arbitration action where they were not given proper notice of a hearing. The panel contained no public arbitrators in contravention of CBOE regulations, and a court had refused to confirm the award. The court found that two important policies are promoted by finding arbitrators immune from suit and dismissed the tort action. First, the integrity of the deci-

845. Id. at 676-77.
847. See Pallante v. Paine Webber, Jackson & Curtis, Inc., Fed. Sec. L. Rep. (CCH) ¶ 92,219 (S.D.N.Y. 1985). In Pallante, the attorney for the plaintiff was assessed fees and costs. The court stated:
Any experienced attorney in securities law must have known that this case arose out of the same factual predicate as plaintiffs' earlier arbitration proceeding and therefore was meritless. While the plaintiffs themselves may have been unable to judge the clear impropriety of this suit, their [experienced] counsel ... must have known not to pursue this litigation.
Id. See also supra notes 101, 512-15 and accompanying text.
848. See supra note 511 and accompanying text.
849. Austern v. Chicago Board Options Exchange Inc., 21 Sec. Reg. & L. Rep. (BNA) 1218 (S.D.N.Y. Aug. 11, 1989). The court found adequate remedy in defeating confirmation of the award. Further, since the CBOE's conduct did not constitute state action, claims of violation of the fourteenth amendment and state due process rights were rejected. Id.
sion-making process would be inhibited by the fear of reprisal from dissatisfied litigants, and second, otherwise people would be reluctant to serve as arbitrators.\footnote{Id.}

G. The Danger of Change

There is danger, however, in developing sophisticated arbitration procedures. Arbitration may become more and more like litigation. Its very advantages—speed and efficiency—can thereby be lost. For example, the new SRO rules require discovery and depositions and, like the courts, require a written record, written reasons for the award, and the like. These procedures all sound very desirable by protecting the investor and permitting a review of the award to be sure it has been reached fairly. But these procedures will add to delay, expense and probably make the process of arbitration even less attractive as an alternative to litigation. It also may have the effect of precluding the small claimant from any effective forum to present his claims.

As one commentator noted regarding the absorption of equity into the law, "[w]hat had started as an alternative dispute resolution process ended up being absorbed by the law, with the result being a hybrid—an equity practice with all the procedures of the law and a legal system with equitable principles ingrained."\footnote{Fletcher, supra note 83, at 135.}

Another commentator notes:

One of the ironies of our civil justice system is that it was derived from the English system, yet now it bears little resemblance to that system. Many of the techniques used today in securities arbitrations do bear a close resemblance to the system from which we derived our rules of law.\footnote{See 19 Sec. Reg. & L. Rep. (BNA) 1387 (Sept. 18, 1987) (describing the SEC recommendations and concluding that they result in making securities arbitration more like litigation).}

Thus, the danger is that the SRO procedures would become too similar to litigation.\footnote{Fletcher, supra note 83, at 134-35.} To make arbitration more formal would be to have it more similar to the institution it seeks to replace—the court. The result will be another legal institution. In time, the process will repeat itself as the legal system absorbs this institution as well.\footnote{Id. at 136 (citing J. Auerbach, Justice Without Law? 96 (1983)).}

The question of revision of the procedures will thus draw into mind Learned Hand's observation that the parties agreeing to arbitration "must be content with its informalities; they may not hedge it about
with those procedural limitations which it is precisely its purpose to avoid.” Arbitration can be fair and still not be a clone of judicial litigation.

X. SOME QUESTIONS REMAIN

Rodriguez de Quijas resolved many questions regarding arbitration of 1933 Act claims. There is little doubt that investors can bind themselves through predispute arbitration clauses to give up their right to bring actions in the federal courts for violations of the securities laws of the United States. Yet, a basic question still remains: Should parties who have not knowingly done so be determined to have waived their right to a judicial hearing regarding matters of such great public concern such as violations of the securities laws?

While significant changes have occurred in securities arbitration since Wilko, and while the use of arbitration has been established not to be devastating in terms of its result, can it be said to be a “further erosion of investor protection?” Is it not the case that the investor-consumer would anticipate that arbitration, even if he or she is made aware of it in opening an account, will go to contract disputes and not to questions of violation of the laws enacted for investor protection and to enhance the integrity of the marketplace for securities? As one commentator noted, “[T]he risk of a potentially incorrect decision made by an arbitrator in a securities fraud case is simply too great to be justified by the reduction in costs.”

One of the first questions relates to the forums from which most broker-arbitration agreements permit the customer to select. If the forums to resolve such disputes are located in a remote place, or in places where the customer might feel intimidated, due process may not be achieved.

856. Katsoris, supra note 39, at 387.
857. Of course, there is really no reason a customer would sign a predispute arbitration clause if he or she knew the rules—the SRO rules require arbitration of members upon customer demand anyway. See supra text accompanying note 85.
859. Lusardi, supra note 264, at 575.
860. See Comment, supra note 111, at 410. There is “an extreme likelihood [this] will operate against the best interests of an investor . . . against public policy — and the manifest intent of the securities acts.” Id. (emphasis original). See also supra note 111 and accompanying text.

But see the oral argument comments of counsel for the defendant in Rodriguez de Quijas in response to a question raised by Justice O’Connor. The lawyer indicated that arbitration would not necessarily take place in New York City and
In a logical extension of judicial preference for arbitration, it seems that ultimately the courts will be asked to review the fairness of waivers of the right to litigate rather than arbitrate in securities, antitrust, and other commercial dealings. \textsuperscript{861} Industries other than securities will no doubt want to include predispute arbitration provisions as a matter of course in their dealings with customers and clients. When those industries are affected with a public interest, the question remains: Is the resolution of questions by arbitration contrary to long-standing tradition to provide complete judicial relief in these other statutorily protected areas? \textsuperscript{862}

So will the result be development of an arbitration process more responsive to customer needs by the industry which the securities laws seek to police, and will this changing process meet the demands of the public and judicial scrutiny as providing a fair forum for the resolution of such disputes? If the SROs and regulators effectively change the arbitration process to make it more judicial-like, there will be little need to complain since the claims will be processed in a responsible manner. In reality, they must eventually meet the demands of the marketplace and instill public confidence in the process of securities arbitration.

If, on the other hand, the SROs and regulators do not continue to reform arbitration and gain this public acceptance, the legislative bodies of the federal and state governments will perhaps determine that the public good demands judicial review of all securities disputes. The burden on the courts will then increase. Is that so bad? After all, if the courts are burdened by large caseloads, should the result be to throw those who look to the judiciary for protection to the very persons against whom they seek redress—in this case, industry-sponsored and, in many cases, subsidized decision-makers?

In fact, predispute arbitration contracts are used to reduce costs, including those relating to dispute resolution. Consequently, the customer may be realizing these cost savings through lowered commission fees. But has the customer really determined on his own that he wants

\textsuperscript{861} See Cain, supra note 176, at 83.

\textsuperscript{862} Id. See also Lusardi, supra note 264, at 576.

[I]t would be incongruous for the Court to conclude that an arbitration based on a pre-dispute agreement was incapable of dealing with the issues involved in a securities fraud case, in light of the fact that courts have routinely permitted arbitration based on post-dispute agreements, or when the parties to the agreement are members of securities self-regulatory organizations. Courts have increasingly accepted the proposition that the arbitral decision-making process is reasoned and expert.

\textit{Id.}
these advantages, and is the price he pays this broker worth the protections he gave up?

Do McMahon and Rodriguez de Quijas really reflect congressional intent regarding the enforcement of the securities laws?\textsuperscript{863} If not, and Congress intended investors to have free access to the federal courts, as many feel the securities laws seem to indicate, it will now take congressional action to restore to the investor the right to knowingly and freely waive that right.\textsuperscript{864} To enforce present predispute arbitration clauses which a customer has probably not read, or if he has read them he may not realize their significance, is probably unfair. In an industry clothed with a national interest, regulation can protect the public who desire to buy and sell in the industry marketplace. Both Congress and the courts will have to look carefully at this question of knowing waiver. Alternatively, self-regulation can also be used to foster this goal to protect public good.

XI. CONCLUSIONS AND RECOMMENDATIONS

The securities industry can avoid review by the courts, regulators or legislative action concerning predispute arbitration agreements easily by making sure that their brokerage customers (whether margin, cash, commodities, or options) understand what they are agreeing to when

\textsuperscript{863} Justice Blackmun did not think that Congress had abrogated the Wilko position in the 1975 amendments to the Exchange Act providing for SEC supervision of the arbitration process of the SROs. See supra note 259-65 and accompanying text. He felt Congress was in accord with Wilko, as would seem to be supported by the Conference Report indicating the "clear understanding of the conferees that this amendment did not change existing law, as articulated in Wilko v. Swan." H.R. Conf. Rep. No. 229, 94th Cong., 1st Sess.91, 111, reprinted in 1975 U.S. Code Cong. & Admin. News 179, 321. Blackmun certainly was correct that Congress did not take any affirmative action to overturn Wilko, despite that finding by the majority. See also Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 242-69 (1987) (Blackmun, J., concurring and dissenting).


\textsuperscript{864} This assumes that the states will not adopt legislation requiring voluntary assent to arbitration in the securities area, or perhaps in all contracts. See supra notes 793-829 and accompanying text discussing the Massachusetts regulation and the Connolly holding that the blue sky regulations are invalid, but leaving open this issue.

In McMahon, Justice Blackmun called for congressional action to reverse Wilko and again place the investor in an advantageous position, rather than at a disadvantage in industry-controlled arbitration. Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 259-61 (1987) (Blackmun, J., concurring and dissenting). Justice Stevens argued that since Wilko the longstanding interpretation by the courts precluded arbitration of securities claims under the Exchange Act and any mistake in interpretation of legislative intent "is best remedied by the Legislative . . . Branch." Id. at 269 (Stevens, J., concurring and dissenting).
opening an account. Due to the oligopolistic nature of the securities industry, an industry response can come about as easily as have the industry required customer contracts which almost uniformly contain non-negotiable predispute arbitration clauses. The SROs can continue and expand requirements that action be taken by all members. A new industry standard of behavior will result. Clearly, there is no place for the industry to adopt the position that if the customer does not want to give up his right to litigate claims he "'then shouldn't open a brokerage account.'"\(^{865}\) This ostrich approach will work against the industry in the long-run.

To ensure that an unsophisticated customer has not been abused by industry power to dictate terms of this relationship, the industry and SEC should go a step further than the most recent pronouncements. They should first require separate agreements regarding arbitration, which may not be a condition to opening an account;\(^{866}\) second, undertake an affirmative disclosure\(^{867}\) to be sure that the customer knows the significance of such an agreement and voluntarily agrees to it;\(^{868}\) third,

\(^{865}\) Moulin, supra note 41, at 467 (Congressman Markey quoted the president of the SIA).

\(^{866}\) Such is the practice in the commodities industry. See Robbins, supra note 3, at 42; Katsoris, supra note 99, at 374-75 n.85 (noting a possible alternative—the 45 day period to seek reparations under the Community Exchange Act § 14 and the CFTC regulation (17 C.F.R. § 180.3(b)(3) (1988))). It may be that a similar period necessary for the customer to elect a resolution in all other forums other than the arbitration setting could be imposed in all securities arbitration cases. Id. "To hold otherwise would make a mockery of the law of contracts." Id. See also supra note 167 and accompanying text.

\(^{867}\) See Rakoff, supra note 47, at 1274. "The carrier cannot merely recite in a form document the existence of choice and direct its agents to be silent" when the customer is signing, probably without carefully reading, the myriad of documents used to open a cash, margin and/or commodities account. Id.

\(^{868}\) Two of the issues which should be disclosed to customers are the costs of litigation versus arbitration and recovery percentages of claims in each. See supra notes 47-60 and accompanying text for a more detailed analysis indicating that arbitration may be the best way for a customer to proceed due to its lower costs, no matter what the impact of arbitration awards. Of course, there is reason why arbitration results in a higher percentage of claim recoveries—in most instances the claims themselves are limited to those with which the customer feels he is most comfortable and likely to succeed. Perhaps in litigation, attorneys will throw in every possible claim and they will measure the recovery.

Nevertheless, the present state of arbitration in the securities industry is principally flawed by the take-it-or-leave-it nature of the brokerage contract as now presented to the customer. It makes more sense, this author believes, to provide election after giving information regarding the two processes available for dispute resolution. Let the customer decision be made on full and fair information from which the customer can make an informed choice. If the commission rates are different, the differences should be reflected in costs to the firm, and this election can be made on a full and fair information basis as well. In this manner, the election will then be an informed choice by the consumer.

With the exception of the two-tier commissions, disclosure and non-mandatory
consider establishment of arbitration bodies independent of the exchanges or industry for securities disputes; and fourth, at the very least, continue revision of the process to ensure that the arbitration process and procedures are fair and equitable. After all, knowledge in the marketplace is the purpose of the securities laws. This should apply to knowledge of the marketplace as well, and disclosure is a keystone of any informed customer. The SICA disclosure rule is a step in the right direction.

If the above elements exist, even in an industry-monitored investor-broker relationship, the customer should not complain. The change from judicial to arbitral forum will not mean there is a radical difference in ultimate result in such a case. He or she will have been well served by free choice and the efficient, economical and speedy resolution of disputes in arbitration. If not, in the long-run the customer should be able to avoid mandatory predispute arbitration, and probably will ultimately be allowed to do so, whether by state or SEC regulation, or court or legislative action overturning the effect of McMahon and Rodriguez de Quijas.

To paraphrase the Wilko Court: "'[L]et the seller also beware’—and be responsible."