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Legislation to Repeal Mandatory Securities Arbitration

Introduction

Virtually all securities broker-dealers and reportedly most investor advisors require their customers to agree that disputes that may arise between them must be resolved through arbitration rather than through lawsuits filed in federal or state courts. Critics of this practice argue it unfairly denies investors the right to seek redress through other avenues. Proponents of the practice argue arbitration results in fair outcomes at less cost to the parties involved.

Two companion bills—S. 1171 and H.R. 2620, which was marked up by the House Financial Services Committee (HFSC) on November 16, 2021—would prohibit financial intermediaries from mandating that their customers submit to arbitration to resolve disputes instead of litigating them through federal or state courts. To do so, the bills would amend the Securities Act of 1933 (P.L. 73-22) and the Investment Advisers Act of 1940 (P.L. 76-768). Specifically, they would prohibit broker-dealers, investment advisers, and other intermediaries from incorporating mandatory arbitration clauses in customer agreements. Supporters argue that this would more fairly give investors the benefit of seeking redress in several ways.

Also, under the bills, customer agreement prohibitions on class action suits would be banned. If enacted, the legislation would also void mandatory arbitration agreements that were in effect before the bills became law.

The legislation would also amend the Securities Exchange Act of 1934 (P.L. 73-291) to require that security exchange rules not allow the listing of any company whose bylaws, governing documents, or contracts provide that disputes between shareholders and the company would be subject to mandated arbitration.

Supporters of S. 1171 and H.R. 2620 say that the bills would ensure that securities firm customers would no longer have to surrender their rights to litigate disputes when they engage with the firms. Detractors acknowledge this outcome but argue that the reform would ultimately kill securities arbitration, ending the benefits it provides to investors.

Background

The role of arbitration. Clients of broker-dealers and investment advisors, who provide them with investment recommendations, may allege that they have engaged in various illegal acts, such as breach of fiduciary duty (for advisors), negligence, unsuitable investment recommendations (historically for brokers), conflicts of interest, misrepresentation, omissions of material facts, and fraud. Historically, such investor disputes could be resolved through various avenues, including litigation in court or arbitration.

Growing prevalence of arbitration. Court cases have been instrumental in the growing use of mandatory securities arbitration. According to one analysis, before the late 1980s, a minority of broker-dealers had *voluntary* customer arbitration agreements. Since then, two U.S. Supreme Court rulings, Shearson/American Express v. McMahon, 482 U.S. 220 (1987) and R. de Quijas v. Shearson/Am. Express, 490 U.S. 477 (1989), are widely seen to have established that the securities industry can compel investors to have their disputes adjudicated through arbitration forums as indicated in their customer arbitration clauses. Now mandatory arbitration provisions are said to be nearly universal.

The brunt of the policy debate surrounding mandatory arbitration clauses for securities transactions revolves around broker-dealer arbitration hearings conducted by the Financial Industry Regulatory Authority (FINRA)—the self-regulatory organization that is the principal regulator of broker-dealers and has 8,000 or so arbitrators. The Securities and Exchange Commission (SEC) oversees FINRA. Arbitration hearings resolve a fraction of the total number of customer disputes filed with FINRA, the vast majority of which are settled prior to an arbitration hearing through direct negotiation or mediation.

For cases involving investment advisers, which group oversees the arbitration is less clear-cut. Some are dual registered as investor advisors and broker-dealers and may undergo FINRA arbitration. However, for those who are solely registered as investor advisors, arbitration is typically conducted by one of two alternative dispute resolution groups, the American Arbitration Association (AAA) and an arbitration group known as JAMS (formerly known as Judicial Arbitration and Mediation Services). On a few occasions, FINRA, also conducts some investor advisor arbitrations where the advisor is not dual registered.

Most of the discussions and research on mandatory securities arbitration has focused on FINRA broker-dealer arbitration, not arbitration involving investor advisors. This may stem from the fact that until the past decade or so the use of mandatory arbitration in what many argued was the more deferential to customers fiduciary-based advisory industry was said to be limited. It is now said to be typical. As such, the arguments presented in the next section focus on FINRA broker-dealer arbitrations, except where otherwise noted.

The provisions that would ban mandatory arbitration between shareholders and their firms. The backstory behind the aforementioned legislative provisions that would ban mandatory arbitration agreements between shareholders and firms dates back several years. At that time, a then-SEC commissioner, some academics, and a number of corporate lawyers expressed support for the SEC's consideration of a policy that would allow public companies to incorporate language into their initial public offerings requiring mandatory arbitration to resolve shareholder disputes. Some observers argued that it would have reversed a long-standing SEC position that such mandatory arbitration arrangements would violate the Securities Exchange Act of 1934. The intent behind initial legislative proposals would largely appear to be that of telling the SEC to stay with the status quo.

Since then, the only public commentary on the subject by SEC officials appears to have been made by SEC Chair Gary Gensler during a May 6, 2021, hearing held by the HFSC. He remarked that the SEC has consistently informed companies that it would not be advisable for them to incorporate mandatory arbitration language into their corporate charters. He explained that the public needs to be able to seek judicial redress.

Arguments that Lend Support to the Legislation

Support for the bills has come from various groups, including the Americans for Financial Reform (a coalition that supports tighter financial regulation), the North American Securities Administrators Association (NASAA, an association of state and provincial securities regulators), the American Association for Justice (a trial lawyer advocacy group), and the Public Investors Advocate Bar Association (PIABA, a group of attorneys who represent clients in securities cases). Some arguments that lend support to the legislation are

- Section 921 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) gave the SEC rulemaking authority to "prohibit, condition or limit the use of mandatory pre-dispute arbitration agreements" if it finds that doing so protects investors and is in the public interest." (The SEC has not used the authority.)
- At a March 2, 2021, HFSC hearing, Gensler said: "While arbitration has its place, it's also important that investors—or, in that case, customers—have an avenue to redress their claims in the courts."
- In 2019, a national opinion poll of investors found that 83% of respondents indicated that they wanted a choice to pursue their disputes in civil court or in arbitration instead of solely through arbitration. (NASAA)
- If the bills' reforms are adopted, "healthy" competition in the securities dispute arena could result. And courts may not be clogged, as some assert, as smaller-sized claims remain with FINRA. (Frenkel, 2021)
- Civil litigation may generate a positive externality with respect to having a deterrent effect on bad corporate behavior. (Shapira, 2019)
- FINRA does not allow class action arbitrations and provides for explanations of the basis of an award only when requested by both disputants, reportedly a rare occurrence. (Shapira, 2019)
- Parties involved in FINRA arbitrations essentially relinquish their right to an internal appeal of a decision. They also have more limited opportunities for discovery relative to civil litigation. (Tadjedin, 2021)
- One critique of investment advisory arbitrations, found in comments by PIABA officials on advisory firm arbitrations done by AAA and JAMS, expresses concern that the costs for investors of such dispute resolutions can reach the tens of thousands of dollars, potentially putting them out of reach for many investors. (PIABA)

Arguments Critical of the Legislations' Intent

Among critics of the bills are the U.S. Chamber of Commerce (a business advocacy group) and the Securities Industry and Financial Markets Association (a securities firm trade group). Various arguments or observations are critical of the legislation. Some that lend support to the notion of arbitration as the default form of dispute resolution are

- Various research on FINRA arbitrations has found that they satisfy most generally recognized standards of fairness. (Black, 2010)
- FINRA arbitration tends to be generally faster than litigation. (FINRA)
- A former president of FINRA's dispute resolution forum asserts that, compared to litigation, claimants before FINRA arbitration are able to plead a much wider range of alleged violations. (*New York Times*, 2014)
- Under FINRA's rules, customer arbitration agreements cannot ban civil class actions through the courts.
- Various legal experts have said that many investors would not have an opportunity to resolve their disputes were it not for the existence of the more "investor friendly" FINRA arbitration. (*New York Times*, 2014)
- According to an academic's analysis, most securities cases would cost investors much more if they were litigated, which is largely due to attorney's fees. (*Forbes*, 2009)
- FINRA has made significant improvements to its arbitration protocols over the decades, including reforming the long-standing requirement that arbitrations include an arbitrator with securities industry connections. Arbitration panels can now solely consist of "public" arbitrators with no connections to the securities industry. (PIABA)

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