1989

New Protections in Arbitrating Public Securities Disputes in the Wake of McMahon: Foregone Conclusion or Will-O'-The-Wisp

C.M.A. McCauliff

Robert C. Tyms

Follow this and additional works at: http://digitalcommons.law.villanova.edu/vlr

Part of the Securities Law Commons

Recommended Citation


Available at: http://digitalcommons.law.villanova.edu/vlr/vol34/iss1/2

This Article is brought to you for free and open access by Villanova University Charles Widger School of Law Digital Repository. It has been accepted for inclusion in Villanova Law Review by an authorized editor of Villanova University Charles Widger School of Law Digital Repository. For more information, please contact Benjamin.Carlson@law.villanova.edu.
NEW PROTECTIONS IN ARBITRATING PUBLIC SECURITIES DISPUTES IN THE WAKE OF McMAHON: FOREGONE CONCLUSION OR WILL-O'-THE-WISP?

C.M.A. McCauliff* and Robert C. Tyms**

Table of Contents

I. THE ARBITRABILITY OF IMPLIED CAUSES OF ACTION ARISING UNDER SECTION 10(b) OF THE SECURITIES EXCHANGE ACT ................................................................. 28
   A. The Early Balance Between the Policies of the Securities Acts and the Federal Arbitration Act ................................. 31

II. COURT-ORDERED ARBITRATION OF EXCHANGE ACT CLAIMS .............................................. 40

III. THE NEED FOR INCREASED FAIRNESS IN ARBITRATION PROCEDURES IN THE AFTERMATH OF McMAHON ........ 45
   A. Present Provisions for Securities Arbitration ............................. 46
   B. Current Suggestions for Improvement of Securities Arbitration ........................................ 50

IV. CONCLUSION .......................................................... 60

Harply more than four months before Black Monday, October 19, 1987, the United States Supreme Court gave the securities industry great leverage in choosing the forum for resolving disputes with their customers by recognizing arbitration as a contractual alternative to litigation.1 The American Arbitration Association (AAA) reports that requests for arbitration of public securities disputes through its auspices alone have risen by fifty percent since Black Monday.2

---

* Professor, Seton Hall University School of Law, A.B. Bryn Mawr College, Ph.D. University of Toronto, J.D. University of Chicago.

** Carella, Byrne, Bain & Gilfillian, A.B. St. John's University, Minnesota, M.A. New York University, J.D. Seton Hall University. The authors would like to thank Neil B. Cohen, Robert E. Meade and Robert A. Love.


2. Statistics provided by AAA Department of Case Administration, 140 W. 51 St., N.Y., N.Y. 10020; see also Schiffers & Goldwasser, When Your Broker Fouls Up, CHANGING TIMES, Jan. 1988, at 65-66 (identified main areas of complaint...
arbitration in the AAA and other arbitral systems provided by the national securities exchanges and registered securities associations will provide the first large-scale test of how arbitration is being received by the investing public. If arbitration is perceived as fair, it will enhance the investor's confidence in the securities markets. Furthermore, it will provide some docket relief for federal district courts already deemed to be overburdened with securities cases. As long ago as 1975, the Court had acted to reduce standing in securities cases through the buyer-seller requirement. At the same time, Congress had acted to enlarge the power of the Securities and Exchange Commission (SEC) over arbitration. The philosophy embodied in both of those actions played a role in permitting the Court to embrace arbitration of public securities disputes in 1987.

Thirty-five years ago, the Supreme Court viewed both arbitration and the nature of securities suits very differently. It held in Wilko v. Swan that claims arising under section 12(2) of the Securities Act of 1933 (1933 Act or Securities Act) were not arbitrable and that a district court could not compel arbitration in accord with a preexisting arbitration agreement. Since that deci-

3. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). The Court adopted the so-called Birnbaum rule of Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952), and held that the implied private right of action under rule 10b-5 was limited to actual "purchasers" or "sellers" of securities. Blue Chip Stamps, 421 U.S. at 730-31. However, the Court rejected the exception to the Birnbaum rule created by the court of appeals which granted a private right of action under rule 10b-5 to an offeree of an offering of securities made pursuant to an antitrust decree. Id. at 749-50. The Court's holding marked a reaffirmation of "virtually all lower federal courts facing the issue in the hundreds of reported cases presenting this question . . . ." Id. at 731 (citing, inter alia, Sargent v. Genesco, Inc., 492 F.2d 750, 763 (5th Cir. 1974); Landy v. FDIC, 486 F.2d 139, 156-57 (3d Cir. 1973), cert. denied, 416 U.S. 960 (1974); Haberman v. Murchison, 468 F.2d 1305, 1311 (2d Cir. 1972); Simmons v. Wolfson, 428 F.2d 455, 456 (6th Cir. 1970), cert. denied, 400 U.S. 999 (1971); City Nat'l Bank v. Vanderboom, 422 F.2d 221, 227-28 (8th Cir.), cert. denied, 399 U.S. 905 (1970)).


Any person who . . .

(2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the
ARBITRATING SECURITIES DISPUTES

In the United States, numerous lower courts have extended the *Wilko* doctrine to bar arbitration of rule 10b-5 claims under section 10(b) of the Securities Exchange Act of 1934 (1934 Act or Exchange Act), holding that public policy concerns and legislative history compel resolution in a judicial forum and that the similarities of the 1933 and 1934 Acts outweigh any differences. On June 8, 1987, the Court rejected the lower courts' extension of *Wilko*, holding in *Shearson/American Express, Inc. v. McMahon* that the Federal Arbitration Act of 1925 (FAA) requires the enforcement of predispute arbitration agreements with respect to section 10(b) claims.

The objective of this article is to examine the need for rigor-

---

7. See, e.g., Surman v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., 733 F.2d 59 (8th Cir. 1984); Sawyer v. Raymond James & Assoc., 642 F.2d 791, 792 (5th Cir. 1981); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017 (6th Cir. 1979); Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Moore, 590 F.2d 823 (10th Cir. 1978).


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. . . .

ous SEC oversight of brokers' self-regulatory procedures and modification of present arbitration procedures.

I. THE ARBITRABILITY OF IMPLIED CAUSES OF ACTION ARISING UNDER SECTION 10(b) OF THE SECURITIES EXCHANGE ACT

Anglo-American jurisprudence had traditionally manifested a jealousy for the jurisdiction of courts and a repugnance for enforcing arbitration agreements in the belief that arbitration ousted courts from their jurisdiction.\(^\text{12}\) Furthermore, the fear that an arbitrator could not offer the full range of remedies of a court made judges unwilling to require a party to submit his controversy to an inadequate tribunal.\(^\text{13}\) Nevertheless, by 1925, a slight change in attitude allowed Congress to enact the FAA which was designed to overcome the tradition of hostility and to declare arbitration agreements enforceable.\(^\text{14}\) In so acting, Congress acknowledged the acute congestion in the federal courts and devised a method of promoting arbitration as a quick and inexpensive alternative to litigation. To encourage arbitration as an alternative means of dispute resolution, the FAA places arbitration agreements on the same footing as other contracts. Section 2 of the FAA directs courts to enforce arbitration agreements except when legal or equitable grounds exist for the revocation of any contract.\(^\text{15}\) Section 3 provides for a stay of judicial proceed-

\(^{12}\) Malcolm and Segall, supra note 9, at 728-29.


\(^{15}\) 9 U.S.C. § 2 (1982); Mitsubishi, 473 U.S. at 625-26. The equitable and legal grounds upon which a court can refuse to enforce an arbitration award, some of which are mentioned in the text accompanying footnote 18, are detailed in sections 10 and 11 of the FAA. Section 10 provides:

In either of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration—

(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.
ings on any issue referable to arbitration pending that arbitration. 16 Section 4 permits a party to an arbitration agreement to petition for an order compelling arbitration pursuant to the terms of that agreement. 17

Arbitration awards must be confirmed by the courts unless exceptional circumstances are present that would justify modification or correction. 18 These circumstances include fraud, gross misconduct by the arbitrator and the granting of awards which exceed the arbitrator's authority. 19 The FAA represents a "strong national policy favoring the recognition of arbitration agreements as means of resolving private conflicts short of the more costly and disruptive avenue of litigation." 20 In furtherance of this national policy, courts construe arbitration clauses to permit arbitration of the issue presented for adjudication whenever possible. 21 Any doubts concerning the arbitrability of an issue, including doubts about the construction of a statute, must, as a matter of federal law, be resolved in favor of arbitration. 22

(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 rehearing by the arbitrators.


Section 11 provides:

In either of the following cases the United States court in and for the district wherein the award was made may make an order modifying or correcting the award upon the application of any party to the arbitration—

(a) Where there was an evident material miscalculation of figures or an evident material mistake in the description of any person, thing, or property referred to in the award.
(b) Where the arbitrators have awarded upon a matter not submitted to them, unless it is a matter not affecting the merits of the decision upon the matter submitted.
(c) Where the award is imperfect in matter of form not affecting the merits of the controversy.

The order may modify and correct the award, so as to effect the intent thereof and promote justice between the parties.

Id. § 11. For a discussion of the grounds recommended by the Securities Industry Conference on Arbitration for vacating an arbitration award, see infra notes 173-76 and accompanying text.

18. Id. § 9.
19. Id. §§ 10-11. For a discussion of the grounds recommended by the Securities Industry Conference on Arbitration for vacating an arbitration award, see infra notes 173-76 and accompanying text.
21. Id.
22. Id.; see, e.g., Southwest Indus. Import & Export, Inc. v. Wilmod Co., 524
Eight years after it passed the FAA, Congress enacted the Securities Act of 1933. The 1933 Act, which was designed to protect the investing public from fraud, created a regulatory scheme to govern the behavior of issuers, underwriters, dealers and brokers engaged in the sale of new or recently issued securities. The 1933 Act requires the seller to file a registration statement with the Securities and Exchange Commission and to make full and complete disclosure of all material facts surrounding the offering. Section 12(2) of the 1933 Act provides a remedy for misstatements or half-truths in connection with the sale or offer for sale of a security in interstate commerce. This remedy takes the form of an express civil right of action against a broker or dealer, enforceable by the purchaser who claims to have been defrauded.

Remedial rather than penal in nature, the 1933 Act provides compensation only for losses actually incurred; thus, there are no provisions for treble or punitive damages. Section 12(2) of the 1933 Act established three significant modifications to common law actions for fraud and misrepresentation: it created an express statutory cause of action; it shifted the burden of proving (non-)negligence to the defendant, thus eliminating the requirement of scienter; and it gave the plaintiff the right to proceed in either state or federal court to enforce the cause of action, thus effectively barring the defendant from removing the action to federal court. Moreover, to ensure the customer of his statutory rights, section 14 of the 1933 Act voids any attempt to circumvent or waive any of its provisions. In determining the arbitrability of

F.2d 468, 470 (5th Cir. 1975) (courts should give full effect to arbitration clauses to ease court congestion and to effectuate intent of parties); Galt v. Libbey-Owens-Ford Glass Co., 376 F.2d 711, 714 (7th Cir. 1967) (arbitration clauses should be construed whenever possible in favor of arbitration); Lundgren v. Freeman, 307 F.2d 104, 110 (9th Cir. 1962) (same).

25. Id. § 77l(2).
26. For the text of section 12(2), see supra note 6.
28. 15 U.S.C. § 77k(g) (1982). Section 11(g) of the 1933 Act provides: “In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public.” Id.
30. Id. at 624.
claims arising under the Securities Act of 1933 and the Securities Exchange Act of 1934, courts have been compelled to resolve conflicts between important federal policies underlying those two Acts and the FAA.32

A. The Early Balance Between the Policies of the Securities Acts and the Federal Arbitration Act

In Wilko v. Swan, a question was raised about the meaning of section 14's "nonwaiver" provisions. The Wilko Court determined that the question was whether an agreement to arbitrate a future controversy is a "condition, stipulation or provision binding any person acquiring any security to waive compliance with any provision" of the Securities Act which section 14 declares void.33 In 1951, plaintiff Wilko purchased 1,600 shares of common stock of Air Associates, Inc., for a price of nearly $30,000. In his complaint, Wilko alleged that he was induced to make the purchase by false representations that pursuant to a merger contract with the Borg Warner Corporation, Air Associates' stock would be valued at six dollars per share over the current market price, and that financial interests were buying up the stock for speculative profit. Wilko alleged that he was not informed that the Air Associates stock he had purchased had been sold by a director of, and counsel for, Air Associates, Inc., who was also dealing through the same broker. Two weeks after the purchase, Wilko sold his stock at a loss, and he claimed that amount in damages. The respondent brokerage firm moved to stay the trial of the action pursuant to section 3 of the FAA. The relevant clause of the predispute margin agreement provided that "[a]ny controversy arising between us under this contract shall be determined by arbitration . . . ."34 The district court denied the motion on the basis that the arbitration agreement deprived the plaintiff of the court remedy afforded by the 1933 Act and was thus unenforceable.35 The United States Court of Appeals for the Second Circuit reversed.36 The divided court concluded that the 1933 Act did not prohibit arbitration of future controversies and found

---

32. Malcolm & Segall, supra note 9, at 754-55.
33. Wilko, 346 U.S. at 430.
34. Id. at 428-29, 432 n.15.
that the congressional policy favoring arbitration preempted the choice of forum provision of the 1933 Act. 37

The Supreme Court reversed, holding that the intention of Congress concerning the sale of securities is better carried out by invalidating agreements for arbitration of issues arising under the 1933 Act. 38 The Court reasoned that when a securities buyer, prior to any violation, waives his right to sue in courts, he gives up more than a participant in other business transactions. The investor surrenders one of the advantages the Securities Act gives him—a wider choice of courts and venue—and surrenders it before the dispute arises, at a time when he is less able to judge the role which the substantive securities law would play in his particular case. 39 The effectiveness of these “pro-buyer” provisions is lessened in arbitration, especially if the buyer’s case turns on the arbitrator’s subjective findings regarding the alleged violator’s purpose and knowledge of the 1933 Act because arbitrators decide without benefit of judicial instruction on the law. 40 Again, because their award may be made without explanation of their reasons and without a complete record of their proceedings, the arbitrators’ conception of the legal meaning of such statutory requirements as “burden of proof,” “reasonable care” or “material fact” cannot be examined. 41 Power to vacate an award is limited. 42 In unrestricted submissions such as the 1950’s margin agreements envisaged, the interpretations of the law by the arbitrators, in contrast to manifest disregard for the provisions of the Securities Act, are not subject to judicial review for error in interpretation. 43 The Court acknowledged that while on one hand Congress had afforded the advantages of arbitration to participants in transactions subject to its legislative power, on the other hand Congress had provided the Securities Act to protect the rights of investors and had forbidden a waiver of any of those rights. 44

Accordingly, the Wilko Court held that a brokerage firm may not bind a customer to arbitration to the exclusion of his private

37. Id. at 444-45.
38. Wilko, 346 U.S. at 438.
39. Id. at 435.
40. Id. at 435-36.
41. Id. at 436.
42. Id.
43. Id. at 436-37.
44. Id. at 438.
remedies under section 12(2) of the Securities Act. The Wilko doctrine does not prohibit arbitration agreements; it declares them unenforceable when interposed as a defense to a suit under the 1933 Act. The Court thus created an exception to the provisions of the FAA.

Following the Wilko decision, some lower courts extended its reach to bar arbitration of claims brought under the 1934 Act. These courts held that Wilko guaranteed investors the right to litigate rule 10b-5 claims in federal courts, notwithstanding otherwise enforceable arbitration agreements. In extending Wilko's reach to investor claims alleging violations of rule 10b-5, the courts reasoned that the non-waiver provisions of the 1934 Act protected the implied right of action against the effect of an arbitration agreement, as much as if Congress had granted the right textually. Thus, these courts found arbitration of section 10(b) and rule 10b-5 claims unenforceable.

Congress may have tacitly approved this judicial interpretation of its intent when it enacted substantial amendments to the Securities Exchange Act in 1975. Although the 1975 amendments did not specifically address the enforceability of predispute arbitration agreements between the securities industry and its public customers, a conference committee report clearly stated that Congress believed Wilko applied to the 1934 Act and prohibited enforcement of arbitration agreements on section 10(b) and rule 10b-5 claims. The clear understanding of the conferees was 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.

There are similarities in the rights created by the Securities
Act of 1933 and the Securities Exchange Act of 1934. The causes of action available, however, under section 12(c) of the Securities Act and section 10(b) of the Exchange Act are significantly different.\textsuperscript{53} A "right" refers to a set of obligations or duties requiring others to act, or to refrain from acting, in a certain way toward the individual who holds the right.\textsuperscript{54} A "cause of action" on the other hand, contains the elements required to entitle that individual to some form of relief, usually from the courts, for a violation of his right.\textsuperscript{55} The Securities Exchange Act of 1934 represents an expansion of the federal regulation of securities begun in the Securities Act of 1933. The 1933 Act was directed at the conduct of dealers, underwriters and issuers involved in the initial offering.\textsuperscript{56} The 1934 Act regulates actions in the marketplace where these issues are subsequently traded.\textsuperscript{57} Section 10(b) of the 1934 Act makes it unlawful for a seller of a security traded on a national securities exchange to engage in any fraudulent, manipulative or deceitful practice, to make an untrue statement of material fact, or to fail to state a material fact necessary to make a statement not misleading in the sale of any security.\textsuperscript{58} The two Acts have been construed to be \textit{in pari materia} and to be read as one wherever possible.\textsuperscript{59} Both prohibit any waiver of their provisions.\textsuperscript{60} Section 12(2) and rule 10b-5 both create rights for investors by prohibiting various forms of conduct and obligating brokers to adhere to the restrictions of these Acts.

A distinction, however, should be noted in the objectives of the respective Acts. "The 1933 Act was directed first and foremost at the protection of the investing public."\textsuperscript{61} "While the

\begin{itemize}
  \item \textsuperscript{53} Comment, \textit{supra} note 13, at 516.
  \item \textsuperscript{54} \textit{Id}.
  \item \textsuperscript{55} \textit{Id}.
  \item \textsuperscript{56} Comment, \textit{supra} note 29, at 625.
  \item \textsuperscript{57} \textit{Id}.
  \item \textsuperscript{58} 15 U.S.C. § 78j(6) (1982). Section 10(b) of the Exchange Act states:
  \begin{quote}
  It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . .
  (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
  \end{quote}
  \textit{Id}.
  \item \textsuperscript{59} Comment, \textit{supra} note 29, at 625 & n.42.
  \item \textsuperscript{60} \textit{Id}. at 626.
  \item \textsuperscript{61} \textit{Id}. at 625.
\end{itemize}
1934 Act is also intended to protect the public, its primary focus is on the creation and maintenance of an efficient and orderly capital market."62 The introductory comments to the 1934 Act contained in the Senate Report indicate congressional fear that capital, needed by the depression era economy, would be driven offshore unless action was taken to stabilize the securities markets.63 The apprehension over the loss of domestic capital provided impetus for the 1934 Act.64

There are, in addition, significant differences in the statutory language of section 12(2) of the 1933 Act and section 10(b) of the 1934 Act.65 Section 12(2) entitles the investor to an express statutory cause of action. Neither section 10(b) nor rule 10b-5 provides for an express statutory cause of action. Section 10(b) simply makes the prohibited conduct unlawful. As a result, courts have implied a private cause of action for a purchaser who allegedly has been injured by a violation of section 10(b) provisions.66 The existence of an implied private right of action under rule 10b-5 has been declared to "be beyond peradventure."67

The Acts also differ in their jurisdictional provisions. Section 22 of the 1933 Act provides for the concurrent jurisdiction of both state and federal courts.68 Section 27 of the 1934 Act, however, reposes exclusive jurisdiction in the federal courts.69 As a result, a plaintiff seeking relief under the provisions of the 1934 Act has a more restricted choice of forum and venue than a 1933 Act plaintiff.

Moreover, under section 12(2) of the 1933 Act, the seller is forced to assume the burden of proving lack of scienter.70 This shift in the allocation of the burden of proof from the requirements of the common law action of deceit manifested Congress' intention to extend special protection to the investor who as-

---

62. Id.
63. Id. at 625-26.
64. Id. at 626.
65. Id. For the text of section 12(2), see supra note 6. For the text of section 10(b), see supra note 58.
66. Id. For cases recognizing an implied private right of action under section 10(b) and rule 10b-5, see infra note 91.
69. Id. § 78aa.
70. Malcolm & Segall, supra note 9, at 731; see H.R. Rep. No. 85, 73d Cong., 1st Sess., 9-10 (1933) ("[T]he burden of disproving responsibility for reprehensible acts of omission or commission [is] on those who purport to issue statements for the public's reliance."); see also Wilko, 346 U.S. at 431 (1953) ("seller is made to assume the burden of proving lack of scienter").
asserted a claim under section 12(2) of the 1933 Act. The 1934 Act, however, places the burden of proving scienter on the plaintiff. 71

The majority of federal courts, perceiving that the similarities in the two Acts outweighed the differences, proceeded to recognize a private cause of action under rule 10b-5. 72 For many years the Supreme Court also tacitly recognized the circuit courts' extension of Wilko to the Securities Exchange Act of 1934. By repeatedly denying certiorari in lower court cases that extended Wilko to the 1934 Act, the Supreme Court in effect allowed lower federal courts to develop a substantial body of case law which prevented enforcement of arbitration agreements in claims brought under section 10(b) and rule 10b-5. 73 Thus, for two decades, Wilko remained persuasive.


A change in the Supreme Court's point of view developed slowly during the 1970's and 1980's. The first sign that Wilko was losing its force came when the Supreme Court addressed the conflict between the implied right of action and the enforceability of arbitration agreements in Scherk v. Alberto-Culver Co. 74 In Scherk, a contract, which had been signed in Vienna, provided for the transfer of the ownership of a German company from Scherk to Alberto-Culver, along with all rights held by the company to trademarks in cosmetic goods. The contract expressly guaranteed the sole and unencumbered ownership of the trademarks. The contract also contained an arbitration clause providing that any controversy or claim arising out of the agreement or breach thereof would be referred to arbitration before the International Chamber of Commerce in Paris and that the laws of the state of Illinois would apply to any future disputes.

One year after the closing, Alberto-Culver discovered that the purchased trademark rights were substantially encumbered, and it therefore sought to rescind the contract. Scherk refused, and Alberto-Culver brought suit in the federal district court in

71. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212 (1976) (plaintiff's proof of scienter is a prerequisite to action under rule 10b-5); Comment, supra note 29, at 626-27.
72. Note, supra note 49, at 341. For cases recognizing an implied private right of action under section 10(b) and rule 10b-5, see infra note 91.
73. Id. at 342. For cases refusing to enforce agreements to arbitrate claims brought under section 10(b) and rule 10b-5, see supra note 7.
Illinois arguing that Scherk's fraudulent representations concerning the status of the trademark rights constituted violations of section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5.

While not explicitly holding *Wilko* inapplicable to rule 10b-5 claims, the Supreme Court ruled that the predispute arbitration agreement was enforceable because of the crucial differences between the relationship of the parties in *Wilko* and *Scherk*. The Court found that in *Wilko* the arbitration agreement was between a customer and a broker. The contract to purchase the business entities belonging to Scherk, however, was truly an international agreement. If the arbitration agreement, which provided in advance for a specific forum for resolving disputes, had not been enforced, the parties would have been faced with many uncertainties because of the various conflict of laws rules that might be applied.

The Court suggested in dictum that the *Wilko* opinion was not controlling in a case brought under section 10(b) or rule 10b-5, because section 12(2) of the 1933 Act provides "a defrauded purchaser with a 'special right' of private remedy for civil liability . . . [whereas] there is no statutory counterpart of § 12(2) in the Securities Exchange Act of 1934, and neither [section] 10(b) of that Act nor Rule 10b-5 speaks of a private remedy to redress violations of the kind alleged here." The Court observed that while federal case law had established that section 10(b) and rule 10b-5 create an implied private cause of action, the 1934 Act itself does not establish the special right that the Court in *Wilko* found significant.

Once *Scherk* raised questions about *Wilko*, other doubts arose. Because section 29 of the 1934 Act contains a nonwaiver provision similar to section 14 of the 1933 Act, lower courts extended *Wilko* to rule 10b-5 claims arising under the 1934 Act.
Should the general nonwaiver provision of the 1934 Act override the FAA in the same way as section 14 of the 1933 Act does when the 1934 Act’s nonwaiver provision is unsupported by special rights and broad jurisdictional provisions similar to those found in sections 12 and 22 of the 1933 Act?  

Justice White forcefully expressed reservations in his concurring opinion in *Dean Witter Reynolds Inc. v. Byrd.* In *Byrd,* Justice White shifted from his dissenting position in *Scherk* in which he had acknowledged *Wilko* as controlling and section 29(a) of the Exchange Act of 1934 as rendering arbitration clauses void without exception for fraudulent dealings which incidentally have some international features. In his concurrence in *Byrd,* Justice White addressed the question of the enforceability of arbitration clauses as they apply to implied actions under the 1934 Act. He noted that the premise of the controversy before the Court was that Byrd’s 1934 Act claims were not arbitrable. He wrote: “Nonetheless, I note that this is a matter of substantial doubt.” Justice White recalled that the *Wilko* Court in holding arbitration

notes 47-49 and accompanying text. For cases taking this approach, see *supra* note 7.

82. Katsoris, *supra* note 46, at 300-01.
83. 470 U.S. 213 (1985). Byrd invested $160,000 through Dean Witter in 1981, and within eight months the value of his account had declined by more than $100,000. Byrd brought suit in federal district court, alleging violations of sections 10(b), 15(c) and 20 of the 1934 Securities Exchange Act and of various state law provisions. He claimed that a Dean Witter agent had traded in his account excessively and without his consent, had misrepresented the status of his account and had done so with the knowledge, participation and ratification of Dean Witter. When he invested with Dean Witter, however, Byrd signed an agreement that contained a standard provision mandating arbitration of any future controversy arising out of the contract. Thus, the issue was “whether, when a complaint raises both federal securities claims and pendent state claims, a Federal District Court may deny a motion to compel arbitration of the state-law claims despite the parties’ agreement to arbitrate their disputes.” *Id.* at 214.

The United States Supreme Court concluded that state claims must be severed from federal claims and upon a motion to compel arbitration, arbitration of those state claims must be ordered according to the terms of the parties’ agreement. *Id.* at 217. The Court rejected the “doctrine of intertwining,” which would permit a district court, where factually and legally intertwined arbitrable and nonarbitrable claims arose out of the same transaction, to deny arbitration as to the arbitrable claims and try all the claims together in federal court. *Id.* at 216-17. The Court acknowledged the inefficiency of the separate proceedings in different forums which its holding required, but reasoned that the primary policy of the FAA was to ensure judicial enforcement of privately made agreements to arbitrate and not to avoid “piecemeal” litigation. *Id.* at 221.

85. *Byrd,* 470 U.S. at 224 (White, J., concurring).
86. *Id.* (White, J., concurring).
87. *Id.* (White, J., concurring).
agreements unenforceable for claims under section 12(2) of the 1933 Act relied on three interconnected statutory provisions: section 14 of the Act which voids waivers; section 12(2) which creates a special right to recover for misrepresentation not available at common law; and section 22 which provides a plaintiff with a broad selection of possible forums and provides for nation-wide service of process.88

Justice White argued that Wilko's reasoning cannot be mechanically transplanted to the 1934 Act.89 Although section 29 of that Act has an equivalent in section 14 of the 1933 Act, counterparts of the other two provisions are imperfect or absent altogether. Jurisdiction under the 1934 Act is narrower, being restricted to federal courts.90 More important, the cause of action under section 10b and rule 10b-5 is implied rather than express, having been judicially created.91 Accordingly, Justice White reasoned that the phrase from the antiwaiver section of the 1934 Act, "waive compliance with any provision of this chapter," is literally inapplicable.92 Moreover, Wilko's solicitude for the special right to bring a private cause of action established by Congress in the 1933 Act "is not necessarily appropriate where the cause of action is judicially implied and not so different from the common-law action."93 Justice White concluded by remarking that he raised these reservations to emphasize that "the question remains open, and the contrary holdings of the lower courts must be viewed with some doubt."94

This was the situation when McMahon came before the Court. The Court had already ruled that international disputes were ar-

88. Id. (White, J., concurring).
89. Id. (White, J., concurring).
90. Id. (White, J., concurring). For a discussion of the scope of jurisdiction under the 1933 Act and the 1934 Act, see supra notes 68 & 69 and accompanying text.
91. Id. at 225 (White, J., concurring). Although neither section 10(b) nor rule 10b-5 explicitly provides for any civil liabilities, it is well established in federal case law that by making the conduct unlawful, section 10(b) implicitly creates a civil remedy. See, e.g., Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983) (implied private right of action under rule 10b-5 is "beyond peradventure"); Kardon v. National Gypsum, 69 F. Supp. 512, 514 (E.D. Pa. 1946) (implied private right of action under rule 10b-5); cf. J.I. Case v. Borak, 377 U.S. 426 (1964) (implied right of action under section 14(a) of the Securities Exchange Act of 1934). For a discussion of the existence of an implied private right of action under section 10(b) and rule 10b-5, see supra notes 66-67 & 72 and accompanying text.
93. Id. (White, J., concurring).
94. Id. (White, J., concurring).
bitrable, and that state-law securities matters could be arbitrated even though they were intertwined with federal securities claims.

II. COURT-ORDERED ARBITRATION OF EXCHANGE ACT CLAIMS

Between 1960 and 1980, the number of annual filings in federal courts doubled.\(^95\) Recently, federal filings involving the public and members of the securities industry amounted to more than 3,000 civil actions for a one-year period.\(^96\) Between 1980 and 1987, the annual filings of arbitration claims at the New York Stock Exchange almost tripled, increasing from 367 to 1,050, while at the National Association of Securities Dealers, claims escalated from 318 to 2,886, including 789 claims not sent to respondents due to operational, volume and other problems.\(^97\) Without arbitration, many of these disputes might have found their way onto federal court dockets. During the 1970's, the need for speedy, inexpensive resolution of disputes had already emerged as an important factor in assessing the quality of the justice delivery system.\(^98\) Judicial attitudes had changed markedly from the notion that arbitration privatized justice\(^99\) to the administrative consideration that the justice system sorely needed the docket relief which greater reliance on arbitration could provide.\(^100\)

The desire of a brokerage house customer for a federal forum, perhaps even a jury trial, became submerged in the search to relieve the overburdened docket, which was thought to threaten the entire justice system.\(^101\) The newly prevailing image was that of a court system in crisis. The old _Wilko_ issue was transformed in the _McMahon_ case. In the balance, concerns about the quality and effectiveness of arbitration did not ultimately appear significant,

\(^{95}\) Galanter, *Reading the Landscape of Disputes: What We Know and Don't Know (and Think We Know) About Our Allegedly Contentious and Litigious Society*, 31 UCLA L. REV. 4, 37 (1983).

\(^{96}\) Katsoris, *supra* note 46, at 279 n.5.


\(^{99}\) W.H. Blodgett Co. v. Bebe Co., 190 Cal. 665, 667, 214 P. 38, 39 (1923) (agreement between parties to contract to arbitrate all disputes arising thereafter invalid and unenforceable as attempt to oust courts of jurisdiction and create private tribunals).


especially in light of the expanded jurisdiction the SEC has enjoyed over securities arbitration procedures since 1975. The SEC's increased authority enabled it to deal more effectively with defects in the various arbitration procedures.

In that sense, *McMahon* is a momentous decision, stamping the Supreme Court's imprimatur on predispute selection of arbitration. Potentially, this is a development no less significant than the growth of equity in sixteenth-century England, faced with the paralysis of a common law choked by the legislative prohibition against devising new writs. Indeed, over the last decade, commentators have already been heralding the competition which increased use of arbitration will bring to the courts, thus enhancing the utilitarian features of the entire justice delivery system. Especially in the use of substantive law, competition between arbitration and conventional litigation may give rise to new solutions in settling disputes.

In *McMahon*, the Supreme Court ruled that *Wilko* does not extend to the 1934 Act, and, therefore, that such claims are arbitrable if a valid arbitration agreement exists between the parties. The Court in this respect answered the question that Justice White referred to as "open" in *Byrd*. The *McMahon* Court did not expressly overrule *Wilko*. The Court assumed, arguendo, that *Wilko* was decided correctly and that claims arising under section 12(2) of the 1933 Act cannot be compelled to arbitration.

In an opinion written by Justice O'Connor, the *McMahon* Court analyzed the requirements of the FAA and the expansive interpretation of that Act required by subsequent judicial decisions. The Court concluded that the FAA creates a presumption that private contracts to arbitrate disputes are enforceable. In order to overcome the presumption of arbitrability of its claim,
the movant must "demonstrate that Congress intended to make an exception to the FAA for claims arising under ... the Exchange Act, an intention discernible from the text history, or purposes of the Statute."  

In 1984, Eugene and Julia McMahon filed an amended complaint against Shearson/American Express Inc. (Shearson), a brokerage firm with whom they had accounts, and Mary Ann McNulty, Shearson's registered representative. The complaint alleged that McNulty, with Shearson's knowledge, had violated section 10(b) of the 1934 Act and rule 10b-5 by engaging in fraudulent, excessive trading by churning the McMahons' accounts and by making false statements and omitting material facts from her advice. The complaint also alleged a RICO claim and state law claims for fraud and breach of fiduciary duties. Shearson moved to compel arbitration of the McMahons' claims in accord with the arbitration clause in the customer agreements the McMahons signed before the dispute. The district court ordered arbitration of all claims except the RICO claim. The Court of Appeals for the Second Circuit upheld the nonarbitrability of the RICO claim, but by applying Wilko to 1934 Act claims, it refused to require arbitration of the securities claim. The Supreme Court reversed, ruling that the entire dispute was arbitrable.  

First, the Court rejected the argument that section 10(b) claims can be deduced from the antiwaiver provision of section 29(a) of the 1934 Act, because section 29 does not forbid waiver of section 27, which grants exclusive jurisdiction of violations of the 1934 Act to the district courts of the United States. The Court reasoned that section 29(a) only prohibits waiver of the substantive obligations imposed by the 1934 Act and that section 27 is procedural and does not impose statutory duties. Thus, an agreement to arbitrate a future claim merely waives a procedural component of the 1934 Act that gives federal courts jurisdiction. As such, the McMahons' agreement did not waive compliance with any provision of the 1934 Act in violation of sec-

111. McMahon, 107 S. Ct. at 2338.
114. McMahon, 107 S. Ct. at 2343, 2346.
115. Id. at 2338.
116. Id.
Regarding the Second Circuit's reliance on Wilko, Justice O'Connor deemphasized the Wilko Court's finding that Congress included an antiwaiver provision in the 1933 Act, which is similar to section 29(a) of the 1934 Act, to ensure, in part, the protection of investors' rights by compelling the resolution of any 1934 Act claims in federal court rather than in arbitration proceedings. Instead, she interpreted Wilko as holding that the waiver of the right to a judicial forum was unenforceable only because arbitration was judged inadequate to enforce the statutory rights created by section 12(2).

Second, relying on the holdings in Scherk and Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., Justice O'Connor noted that subsequent Supreme Court decisions had rejected Wilko's general suspicion of arbitration, recognizing that arbitral tribunals are capable of handling factual and legal complexities, notwithstanding the absence of judicial instruction. Furthermore, arbitration procedures do not entail any consequential restriction on substantive rights, and although judicial scrutiny of arbitration awards is limited, such review is sufficient to ensure that arbitrators comply with the requirements of the statute. In addition, Justice O'Connor found that the 1975 amendment to section 19 of the 1934 Act, which gave the SEC expansive power to ensure the adequacy of arbitration, indicated that an arbitration agreement does not effect a waiver of the protections of the 1934 Act.

Third, Justice O'Connor rejected the McMahons' argument based on Congress' affirmation, in the 1975 Conference Report, of existing case law as established in Wilko. According to the McMahons, the Report proved Congress knew about and endorsed the lower courts' extension of Wilko to section 10(b) claims. Justice O'Connor found it inconceivable that "Congress could extend Wilko to the Exchange Act without enacting into law any provision remotely addressing that subject." Moreover, she reasoned that the Report could support explana-

117. Id.
118. Id.
119. Id.
121. McMahon, 107 S. Ct. at 2340.
122. Id.
123. Id. at 2341.
124. Id. at 2342-43.
125. Id. at 2343.
tions other than those advanced by the McMahons. She concluded that the statement of congressional inaction in effect left the Wilko issue to the courts.

Thus, the Wilko Court believed that arbitration was ill-suited to promoting the pro-investor policies of the securities laws. Wilko focused on the involuntary nature of the agreement, the lack of legal standards and the absence of a record as well as the restricted power to vacate an award. The McMahon Court dismissed these concerns in light of its assessment of intervening regulatory development. It determined that sufficient protection of investors now exists so that pro-investor policies are not jeopardized when balanced against the benefits of arbitration.

In this five-four decision, on the issue of the enforceability of predispute arbitration agreements under the FAA, the McMahon dissent disputed the majority’s claim that Wilko had been decided only on the basis of the Court’s perception in 1953 of the inadequacy of arbitration for the enforcement of section 12(2) claims. Justice Blackmun expressed concern about limited judicial review, nonreliance on judicial precedent and the absence of a record of the arbitration proceeding. He saw the majority as abandoning the judiciary’s role in the resolution of claims under the 1934 Act and leaving such claims to the arbitral forum of the securities industry at a time when the industry’s abuses towards investors are more apparent than ever. He perceived a need for increased judicial involvement in securities dispute resolution in an era of deregulation when the growth in complaints parallels the increase in securities violations and suggests a market not adequately controlled by Securities Regulatory Organizations (SROs).

In a separate partial dissent, Justice Stevens argued that long-standing judicial construction of an ambiguous statute gives the statute a clear meaning, a judicial gloss as it were, alterable only by the legislature. He concluded that the long-standing interpretation of Wilko creates a strong presumption that any mistakes in the judicial gloss are best remedied by the legislature, not

126. Id.
127. Id.
128. Id. at 2352 (Blackmun, J., dissenting).
129. Id. at 2353-54 (Blackmun, J., dissenting).
130. Id. at 2346 (Blackmun, J., dissenting).
131. Id. at 2358 (Blackmun, J., dissenting).
132. Id. at 2359 (Stevens, J., dissenting).
the judiciary. 133 If the Court had adopted Justice Stevens' view that congressional inaction amounts to ratification, it would have left complex policymaking decisions to a politically accountable Congress. Justice Stevens would have avoided overruling Congress's acceptance of the Court's understanding of Wilko. 134

Ironically, in the aftermath of McMahon and the stock market crash of October 1987, it is now possible that investors increasingly will complain in federal courts about arbitrators who were partial or acted in manifest disregard of the securities laws. 135 This would lead to a clogging of court calendars, the very prospect which arbitration seeks to avoid. Indeed, in an attempt to avoid arbitration entirely, investors have continued to seek access to the federal courts through section 12(2) of the 1933 Act. 136

III. THE NEED FOR INCREASED FAIRNESS IN ARBITRATION PROCEDURES IN THE AFTERMATH OF MCMAHON

The post-Wilko assessment of changes in the regulatory supervision of securities organizations will be examined in the following discussion. In part III of the McMahon Court's opinion, Justice O'Connor called attention to developments in the regulation of the securities industry after the Wilko opinion. 137 She noted that these changes called for a new assessment of arbitration. 138 Changes in the regulatory structure have been spurred in considerable measure by broader public use of the securities mark-

133. Id. (Stevens, J., dissenting).
136. The Supreme Court recently agreed to consider whether claims under section 12(2) of the 1933 Act are arbitrable under predispute broker contracts, and if so, whether investors are compelled to submit such claims to arbitration pursuant to the terms of predispute contracts executed before section 12(2) claims were ruled subject to arbitration. Rodriguez De Quijas v. Shearson/Am. Express, Inc., 845 F.2d 1296, (5th Cir.) cert. granted, 57 U.S.L.W. 3343 (U.S. Nov. 14, 1988) (No. 88-385).
137. See McMahon, 107 S. Ct. at 2340-41.
138. See id.
VILLANOVA LAW REVIEW

kets as investment vehicles.\textsuperscript{139} Broader public investment has been accompanied by a greater number of disputes between the public and members of the securities industry.

Increasingly, these disputes are being channeled into arbitration before forums established by the various SROs, such as the New York Stock Exchange and the National Association of Securities Dealers.\textsuperscript{140} Composite figures of the arbitrations handled by the arbitration facilities of the various SROs (American, Boston, Cincinnati, Midwest, New York, Pacific, Philadelphia Stock Exchanges, Chicago Board Options, Municipal Securities Rulemaking Board and the National Association of Securities Dealers) show that the number of public customer cases decided increased from 410 in 1980 to 622 in 1983.\textsuperscript{141} Awards in favor of the public amounted to approximately fifty percent of those handled by the arbitration tribunals in each of these years.\textsuperscript{142} Similarly, the independent AAA, which provides arbitration services in all fields, has specially adapted its commercial arbitration rules to securities disputes, thus giving claimants a choice of either set of rules. As interest in the impartiality of arbitration grows, more brokerage house customers may be given the option of selecting an AAA forum.\textsuperscript{143}

A. Present Provisions for Securities Arbitration

Since 1975, the SEC has exercised new authority to promote greater fairness and uniformity in securities arbitration. In 1975, Congress amended section 19 of the 1934 Act, empowering the SEC to ensure that arbitration procedures prescribed by the SROs are adequate to enforce the rights of customers against brokerage house members of SROs.\textsuperscript{144}

\begin{itemize}
  \item \textsuperscript{139} Katsoris, \textit{supra} note 46, at 279.
  \item \textsuperscript{140} \textit{Id.} at 280.
  \item \textsuperscript{141} \textit{Id.} at 280 n.7.
  \item \textsuperscript{142} \textit{Id.}
Rules for the administration of securities arbitration disputes differed among the various SROs before 1976. In that year, the SEC initiated discussions directed toward developing a uniform system of grievance procedures for the adjudication of small claims. As a result of these discussions and recommendations from several SROs, a Securities Industry Conference on Arbitration (SICA), consisting of representatives of various SROs; the Securities Industry Association and the public, was established in April 1977. SICA developed a simplified arbitration procedure for resolving small claims of $2,500 or less. SICA then developed a comprehensive Uniform Code of Arbitration (UCA) for the securities industry and prepared an explanatory booklet for prospective claimants. The UCA was adopted by participating SROs during 1979 and 1980.

The UCA establishes a uniform system of arbitration between customers and members of the securities industry for claims submitted pursuant to a written agreement or upon demand by the customer. The SROs have reserved the right to restrict the use of arbitration facilities to the resolution of disputes relating to the activities of the broker-dealers. In addition, disputes must be submitted for arbitration within six years of the date of the event giving rise to the controversy.

The UCA provides that an arbitration panel consists of at least three, but not more than five, impartial arbitrators, with a majority from outside the securities industry unless the customer requests a majority from the industry. The Director of Arbitration of the SRO determines who serves on a particular arbitration panel. The amendments of section 19 added to the SEC's power to change the rules of SROs. Specifically, under section 19(c), the SEC now has authority to "abrogate, add to, or delete from" any SRO's rules in any respect consistent with the objectives of the Exchange Act. Moreover, where the SEC has changed an SRO rule pursuant to its section 19(c) authority, any other SRO rule inconsistent with the SEC amended rule is null and void.

145. Katsoris, supra note 46, at 283-84.
146. Id. at 284.
147. Id.
148. Id.
149. Id. at 285.
150. Id.
151. Id.
Furthermore, the Director is to inform the parties of the names and business affiliations of arbitrators before the date fixed for the initial hearing.  

Each party has the right to one peremptory challenge. If there are multiple claimants, respondents and/or third-party respondents, the claimants have one peremptory challenge, and the respondents and third-party respondents have one peremptory challenge, unless the Director of Arbitration determines that the interests of justice would best be served by awarding additional peremptory challenges. Moreover, to enable the parties to make an informed choice of neutral arbitrators, the arbitrators are affirmatively obliged to disclose "any circumstances which might preclude such an arbitrator from rendering an objective and impartial determination." The materiality and relevance of evidence under the UCA is left to the discretion of the arbitrators who are not bound by rules governing the admissibility of evidence. All parties have the right to representation by counsel at any stage of the proceedings. The UCA does not require the SROs to keep a record of the arbitration. If a record is kept, it must be a verbatim record. If a party requests a record of the proceedings, it must bear the cost of transcription. 

The UCA provides arbitrators and counsel with the full legal subpoena power. However, it encourages the parties to produce witnesses and present proofs to the fullest extent possible without resort to the subpoena process. The UCA further provides that arbitrators can compel the appearance of any employee or associate of any member or member organization of the SRO conducting the arbitration, and/or the production of any records in the possession or control of such persons, members or member organizations. Rule 619 also provides that the parties must cooperate in the voluntary exchange of documents and information as will serve to expedite the arbitration. On the other
hand, extensive pretrial discovery procedures, such as bills of particulars, interrogatories, depositions and notices to produce documents for inspection are not available in arbitration proceedings. Even though the lack of discovery may be fatal to a claimant’s case, the policy of limited discovery is supported by the rationale that arbitration is designed to achieve an economical, expeditious and fair result. Nevertheless, it is undisputable that the broker has the fullest information, including the customer’s file. The major advantages of arbitration are containment of costs and avoidance of delay.

Provisions for pleadings and amendments are set out in the UCA. Proceedings are initiated by filing three executed copies of both the Submission Agreement and the Statement of Claim of the controversy in dispute. The Statement of Claim should specify the relevant facts and the remedies sought. A respondent has twenty business days from receipt of service to submit an executed copy of the respondent’s answer which must specify all available defenses to the Statement of Claim as well as the relevant facts that will be relied upon at the hearing. A respondent, cross-claimant or other adversary who answers only with a general denial that fails to specify all available defenses and relevant facts may be barred from presenting any facts or defenses at the hearing if an adversarial party objects in writing to the Director of Arbitration. Arbitration may take about one year.

The scope of judicial review of an arbitration award is very limited. “If the award is within the submission, and contains the honest decision of the arbitrators, after a full and fair hearing of the parties, a court of equity will not set it aside for error, either in law or fact.” The grounds for vacating an arbitration award are fairly restricted. Unless the law directs otherwise, all awards rendered pursuant to the UCA are deemed final and not

165. Id.
166. Katsoris, supra note 46, at 287 n.52.
168. Id.
169. Id.
170. Id.
171. Id.
172. Schifflers & Goldwasser, supra note 2, at 68.
175. 2 N.Y.S.E. Guide (CCH) ¶ 2628 (1987).
subject to review or appeal.\textsuperscript{176}

SICA considered broadening the scope of review of a securities arbitration award but rejected the notion as being inconsistent with the objectives of simplicity, brevity and economy in arbitration proceedings.\textsuperscript{177} Broadening the scope of arbitration review would require increased costs and more detailed records.\textsuperscript{178} Moreover, broader review would hinder speedy resolution of the dispute because collection of the award would be deferred pending the appeal.\textsuperscript{179}

B. Current Suggestions for Improvement of Securities Arbitration

It is as yet too early to tell whether the McMahon Court's estimate of arbitration procedures will promote the desired ends of reducing litigation of securities disputes and achieving quick, efficient and economic resolution of claims by arbitration. Desirable as these goals are, the inadequacies of supervisory procedures in several areas of regulation militate against the presumption that the public will perceive arbitration procedures as fair in fact and appearance. In an era of deregulation, it is clear that the McMahon decision was launched on a sea of euphoria, a navigable current of which was the assessment of the improved condition of arbitration in securities disputes. That reassuring perception of arbitration facilities was invoked by Justice O'Connor as a basis for her declaration of the diminished importance of Wilko.

Justice O'Connor based her conclusion on her interpretation of Wilko as a judicial decision that the arbitration process in 1953 was "inadequate to enforce the statutory rights created by section 12(2)."\textsuperscript{180} In addition, she found that the 1975 Amendment to section 19 of the 1934 Act, which gave the SEC expansive power to ensure the adequacy of arbitration procedures, was an indication that an arbitration agreement does not affect a waiver of the protection of that Act.\textsuperscript{181} Justice O'Connor summed up the 1975 amendments to section 19 as giving the SEC "broad authority to oversee and to regulate the rules adopted by the SROs relating to customer disputes, including the power to mandate the adoption of any rules it deems necessary to ensure that arbitration proce-

\textsuperscript{176} Katsoris, \textit{supra} note 46, at 291 n.84.
\textsuperscript{177} \textit{Id.} at 291.
\textsuperscript{178} \textit{Id.} at 291 n.84.
\textsuperscript{179} \textit{Id.}
\textsuperscript{180} \textit{McMahon}, 107 S. Ct. at 2338.
\textsuperscript{181} \textit{Id.} at 2341.
To date, it is questionable whether the public derives the same assurance of the adequacy of arbitration procedures from the 1975 amendments to section 19 as does Justice O'Connor. More likely, the investor has the impression, often justified, that his claims are being judged by a forum composed of individuals sympathetic to the securities industry and not drawn from the public. Not infrequently, public arbitrators are attorneys or consultants whose clients have been exchange members or SROs. Investor opposition to and industry support for the process indicate a likelihood that the securities industry has an advantage in a forum under its own control. "The houses basically like the present system because they own the stacked deck." Moreover, the SEC does not assert that its oversight consists of anything more than a general review of SRO rules; its authority does not purport to include a review of specific arbitration proceedings.

With respect to the SEC's general overview of SRO rules, it should be noted that the SEC in recent years has increasingly invoked section 15(b)(4)(E) of the 1934 Act. That section authorizes the SEC to impose sanctions on broker-dealers and their employees who have failed reasonably to supervise employees with a view to preventing violations of the securities laws. The clearly growing concern on the part of the SEC over compliance violations in the industry indicates that the industry's self-regulation is not functioning optimally. For example, self-regulation has not provided branch managers with training in personnel guidelines with respect to inquiries into suspect trading, adopting sanctions for those who obstruct compliance and developing procedures to enforce trading restrictions. Nor has self-regulation provided enforcement mechanisms in the compliance departments of brokerage houses to deal with repeated violations.

182. Id.
183. Id. at 2355 (Blackmun, J., dissenting).
184. Id. at 2355 (Blackmun, J., dissenting) (quoting N.Y. Times, Mar. 29, 1987, § 3, at 8, col. 1 (statement of Sheldon H. Elsen, Chairman, ABA Task Force on Securities Arbitration)).
185. Id. at 2357.
188. Ferrara & Shapiro, supra note 186, at 35.
189. Id. at 44.
190. Id. at 35.
The SEC has identified the following areas of regulation as often lacking adequate supervisory procedures:

(i) failure to supervise customer accounts adequately, particularly option accounts, for unsuitable, unauthorized and excessive trading (churning) in customer accounts;

(ii) failure to detect or investigate reasons for heavy trading in nonrecommended securities and securities in which account executives are affiliated with the issues;

(iii) lax or sloppy procedures in fund and securities transfers and disbursements;

(iv) failure to file required government currency transaction reports on all currency transactions (deposits, withdrawals, exchange or transfers involving a physical transfer in currency) in excess of $10,000;

(v) illegal profits, including certain transactions in which broker-dealers take overly large profits.\(^{191}\)

Such failures have resulted in a growth in complaints about the securities industry, many of which find their way to arbitration. The increase in securities violations suggests a market not adequately controlled by the SROs.\(^{192}\) In addition, there have been complaints that arbitration procedures are rife with conflicts of interest (since arbitrators are peers of the brokerage firms being sued) and are inadequate to enforce statutory rights of customers against broker-dealers.\(^ {193}\) Indeed, at the same time the Court was considering *McMahon*, the House of Representatives received a report on the failure of SROs to handle customer-broker disputes properly.\(^ {194}\)

More specifically, under its section 19 authority, the SEC has been suggesting several improvements to the present provision for arbitration. In general, most of the suggestions for improving

\[^{191}\text{Id. at } 44\text{ (citations omitted).}\]

\[^{192}\text{Id. According to Representative J. Dingell, even the SEC's ability to control the market is questionable. *SEC and Insider Trading: Hearings on H.R. 99-179 Before the Subcomm. on Oversight and Investigations, of the Committee on Energy and Commerce*, 99th Cong., 2d Sess. 1 (Dec. 11, 1986).}\]

\[^{193}\text{*McMahon*, 107 S. Ct. at 2358 (Blackmun, J., dissenting).}\]

the process derive from the FAA itself, the AAA's securities arbitration rules (which give investors more safeguards) and the procedural protections of litigation. Moreover, the suggestions take into account the statutory policies of the FAA as well as those of the federal securities laws which were enacted to protect ill-informed investors from sophisticated brokers.195

The first proposal for improving the tenor and quality of securities arbitration would require that investors be able to elect between arbitration and litigation. Investors are often required to sign an agreement to arbitrate future disputes as a condition to opening an account with a broker. At the time, however, they do not focus on the arbitration clause. The brokerage agreement is usually a standard form in fine print with technical language.196 The standard arbitration clause authorizes the customer to elect the arbitration forum from a list of several organizations, sometimes including the AAA. If the customer does not select the forum within the five days after receipt from the broker-dealer of a notification requesting an election, the broker-dealer becomes authorized to make the election.197

What would make the hypothetical reasonable customer voluntarily enter into an arbitration agreement, other than the assurance of getting a fair deal? This is a large question, which perhaps starts with the least likely assumption first; that the agreement is indeed voluntary. The most important power not included in the SEC's "broad authority" set forth in the 1975 amendments to the 1934 Act gives rise to this threshold issue. Wilko provided judicial protection against mandatory arbitration, and the SEC has no authority to require the brokerage houses to give their customers a choice between litigation and arbitration in the event that a dispute later arises between them.198 Neverthe-

196. Id.
197. Katsoris, supra note 46, at 292 n.86.
198. Schotto v. Laub, 632 F. Supp. 516, 527 (D. Md. 1986) (SEC has "no authority to enlarge or restrict forums legally available to a litigant or to invalidate arbitration clauses that are enforceable under the Act."); Jope v. Bear Stearns & Co., 632 F. Supp. 140, 143 (N.D. Cal. 1985) (SEC release stating "customers should be made aware prior to signing an agreement containing an arbitration clause that such a prior agreement does not bar a cause of action under the federal securities laws" assumes claims under 1934 Act are nonarbitrable and merely interpretive statement by SEC staff and does not have force of law). Before 1975, the SEC had no authority over arbitration procedures. Brief for the SEC as Amicus Curiae Supporting Petitioners at 15, Shearson/Am. Express, Inc. v. McMahon, 107 S. Ct. 2332 (1987).
less, having such a choice may turn out to be very important in the public perception of the fairness of securities arbitration.

Two routes are open to provide the customers of brokerage houses this free choice. First, the SROs may on their own authority simply decide to amend their code, or, second, free choice may become the subject of congressional attention. For example, because it was clear that *Wilko* did not extend to commodities investors, Congress mandated that commodities investors make their own choice between arbitration and litigation. The commodities investor who does not want to sign a predispute arbitration clause is not foreclosed from doing business with the commodities broker. Congressional protection for the commodities investor includes separate disclosure of the clause. The commodities broker simply points out the arbitration clause, explains it and mentions that if the customer wants this feature, a line below the clause is provided for the customer’s signature. While the customer frequently elects arbitration, acceptance is not a condition of doing business. Thus, Congress proved willing to encourage arbitration of commodities disputes but would not mandate arbitration in the absence of the investor’s specific, informed consent. These elements of voluntariness, the customer’s election of arbitration, the broker’s pointing out and calling attention to the arbitration clause and the separate signature line for predispute acceptance of arbitration, may prove adaptable to investors’ contracts with securities brokers. With *Wilko*’s protections removed from customer-broker disputes under section 10, Congress may provide statutory relief.

As it stands now, it may be that few securities brokerage customers are even aware of the arbitration clause at the time they sign their contracts, and even fewer may focus on the possibility of a future dispute with their brokers. One clear policy of the securities laws is to protect ill-informed investors. Its protection may reasonably be extended to disclosure of predispute arbitration clauses. No statistics are available to indicate whether customers are precluded from investing with a brokerage house if


201. *Id*.

they refuse arbitration.²⁰³ Even the SEC's former espousal of a rule which prohibited brokers from binding customers to arbitration is equivocal evidence of preclusion.²⁰⁴ Before McMahon, the most common arbitration provisions were thought to be in options and margin contracts and commodities accounts.²⁰⁵ Given the Court's approbation of predispute arbitration clauses in McMahon, the prevalence of arbitration clauses can only increase in cash accounts.

Even though the individual customer may not be subjectively aware of giving up the opportunity to choose litigation in a future dispute with the brokerage house, he may later become distrustful of brokers and the securities markets in general upon discovery of the waiver, usually after a dispute has arisen. Thus, the assurance of a voluntary selection of arbitration may also serve a symbolic function.²⁰⁶ While the broker's disclosure about the availability and advantages of arbitration may elicit factual, subjective assent to arbitration and insure the investor's cooperation, voluntariness may also serve a public, objective role. Assuring investors that they are not precluded from litigation as a condition of doing business with their brokers underlines the importance of their own choices as informed investors.

Accordingly, as a means of enhancing investor confidence in the efficacy of the arbitration process, the first proposal of investor election of arbitration is to establish a formal basis for ensuring fairness of arbitration procedures. This proposal is concerned with measures for increasing public confidence in arbitration procedures and is directed to confirming the voluntariness and impartiality of the agreement. The proposal is designed to increase public confidence that arbitration procedures are fair in fact and appearance. "[J]ustice should not only be done, but should manifestly and undoubtedly be seen to be done."²⁰⁷ In his statement before the SEC, as long ago as December 8, 1978, Professor Katsoris, a member of SICA, public arbitrator at the New York Stock Exchange and arbitrator for the First Judicial Department in New York, remarked: "To insure . . . public investment we must retain the public's confidence—confidence in the markets themselves and confidence that should a dispute arise, it

²⁰³. Katsoris, supra note 46, at 292 n.86.
²⁰⁴. Id. at 297.
²⁰⁵. Id. at 292 n.86; see also Stansbury & Klein, supra note 195, at 32.
will be fairly resolved. This confidence, however, can only be earned by maintaining a de facto as well as a de jure image of fairness." 208 The de facto image of fairness can be promoted by removing any appearances of adhesion contracts. A contract of adhesion arises when a party with superior bargaining power presents a standardized form contract to a party of lesser bargaining power whose choice is limited to accepting or rejecting the contract without the opportunity to negotiate. 209 While it is true that mere inequality in bargaining power does not make a contract unenforceable, nonetheless, when the arbitration agreement is presented as a precondition to opening an account, the image of de facto fairness is seriously compromised. Therefore, it should be clear to the investor that the agreement is entirely optional.

The second proposal is concerned with the form of arbitration, and is directed to correcting its deficiencies by bringing to arbitration some of the procedural advantages of adjudication, including the appearance of impartiality, which in that system is assured by the presence of the judge. In arbitration, impartiality may be achieved by removing the presumptive institutional bias of the arbitration panel. Members of arbitration panels are often affiliated with the self-regulatory exchanges and are "frequently the targets of the antifraud provisions they are asked to interpret." 210 In disputes involving amounts over $2,500, an aggrieved investor has a right to a panel whose majority is from outside the industry. 211 These "outside" individuals are often either attorneys who represent brokers, or employees of businesses that are outside the securities field but that nevertheless are associated with a business that is a part of the securities industry. 212 The conflicts of interest are more obvious in some cases than in others. The line determining who is "not from the industry" concededly is hard to draw. Panel members should be familiar with the securities industry, but it is clear that application of any proposed classification by SICA requires vigilance and oversight which may not be forthcoming from the SROs.

Again, two routes are available to insure a fair, impartial forum and to eliminate perceived industry bias. One route would

208. Id. at 313.
209. Fletcher, supra note 20, at 445.
210. Malcolm & Segall, supra note 9, at 755.
211. Id.
212. Id.
be to provide the customer with the choice of an independent forum such as the AAA. The other is to improve the impartiality of the arbitration services the SROs provide by amending the rules in the UCA. In the fall of 1987, the SEC's Division of Market Regulation made several recommendations to SICA pursuant to its section 19 authority.\footnote{Franklin, supra note 97, at 5. For another report on the SEC's recommendations, see SEC Staff to Urge Revisions to Industry Arbitration System, 19 Sec. Reg. & L. Rep. (BNA) 1387 (1987).} For example, the SEC proposals call for both greater disclosure and substantive changes on such issues as who may serve as a public arbitrator.\footnote{Franklin, supra note 97, at 5.} Currently, SICA does not restrict lawyers with ties to the securities industry from serving as public arbitrators. The AAA has an informal five-year exclusion of people who "directly or indirectly" act as "counselors, consultants, advisors or attorneys" to an SRO or SRO-affiliate from serving as public arbitrators.\footnote{Friedman, AAA's New Securities Arbitration Rules, 198 N.Y.L.J., Sept. 8, 1987, at 5.} The SEC would go further by banning securities industry retirees from service as public arbitrators, and reclassifying them to serve in industry slots.\footnote{Franklin, supra note 97, at 5.} In addition, the SEC would cut professionals with a certain amount of securities industry business from the public list.\footnote{Id. Some SROs have expressed willingness to create a public perception of impartiality.\footnote{Id. Edward Morris, Director of Arbitration at the New York Stock Exchange, has acknowledged that the exchange wants to avoid the appearance of partiality and pro-industry bias. Id.} Along the same lines, greater disclosure of the backgrounds of the arbitrators on the list would aid customers' selections and use of their peremptory challenges. Similarly, written evaluations of arbitrators by the parties and their counsel could be collected and their substance disclosed for use in future selections. Brokerage houses that regularly use arbitration routinely accumulate this information, thus giving rise to a disparity of information between brokers and customers.

This second cluster of proposals would further modify the form of arbitration by incorporating additional procedural advantages of adjudication. Techniques learned from judicial supervision of litigation could be made available to resolve questions of substantive law\footnote{See Brunet, supra note 104, at 14 (pointing out that the many arbitrations that end without a written opinion leave substantive basis for such decisions in doubt).} or for special difficulties such as abuse of dis-
covery, without resorting to full-blown adjudication.\textsuperscript{220} A process that takes into account protection of the investor sends a signal to the community that the substantive law is worthy of enforcement.\textsuperscript{221} Application of clear legal standards strengthens the image of impartiality and provides a measure by which disputants can assess the neutrality of those who decide or facilitate the decision in a dispute.\textsuperscript{222} Although the SEC has proposed that securities arbitrators be educated in substantive law, SICA would rather leave counsel to brief the arbitrators on the legal issues than make provision for their nonlawyer arbitrators to learn securities law.\textsuperscript{223}

The factfinding function of dispute resolution cannot work properly without mechanisms to compel disclosure of facts.\textsuperscript{224} While some form of discovery is available to the injured investor through subpoena, most other forms are excluded.\textsuperscript{225} The lack of meaningful discovery in arbitration puts the investor at a severe disadvantage, because he may not be able to learn the true facts surrounding the alleged mishandling of his account. Without sufficient discovery, an investor may not be able to determine, for example, the volume of commissions generated by his accounts or the existence of any conflicts of interest. Since brokers usually have more information about the controversy than investors, the lack of sufficient discovery affects investors more than brokers.\textsuperscript{226}

Provision for discovery within the arbitration process could permit equal access to information and at the same time curtail attempts to use discovery as a test of delay or harassment. SICA is considering providing for exchange of documents before the hearing date, if the arbitration panel requests it. Presently, the UCA does not require documents to be turned over, and subpoenaed documents must only be produced at the outset of the hearing.\textsuperscript{227} Expanded use of discovery could help to resolve disputes before the hearing. Again, the AAA already permits hearings at preliminary stages in complex cases and provides for the record-

\begin{footnotesize}
\begin{itemize}
    \item \textsuperscript{220} See id. at 13 (arbitration lacks formal sanctions of Federal Rule of Civil Procedure 37 for abuse of discovery).
    \item \textsuperscript{221} See id. at 17 (noting that risk in resolving a federal securities law dispute through alternative dispute resolution methods is that parties may be able to avoid impact of policies underlying substantive law).
    \item \textsuperscript{222} Franklin, \textit{supra} note 97, at 6.
    \item \textsuperscript{223} Id.
    \item \textsuperscript{224} Brunet, \textit{supra} note 104, at 34.
    \item \textsuperscript{225} Malcolm & Segall, \textit{supra} note 9, at 756.
    \item \textsuperscript{226} Id.
    \item \textsuperscript{227} Franklin, \textit{supra} note 97, at 6.
\end{itemize}
\end{footnotesize}
The SEC has also called for more detailed public information about the nature of the awards, if not for publication of the record of proceedings and explanation of the decision and reasons therefore. Without such reports, meaningful judicial review of arbitration decisions is foreclosed by the absence of a record. An arbitration decision may be overturned when it is in "manifest disregard" of the law, but it is almost impossible to determine whether such disregard has occurred when the basis for the award is undisclosed. As yet, there is little industry acceptance of these suggestions. Thus, the Municipal Securities Rulemaking Board, a SICA member, resists detailing awards. Intimidation of nonlawyer arbitrators unfamiliar with the law and possible evidence of manifest disregard of the law in a written award are the major grounds for the Board's opposition.

In sum, when cases involve issues of public interest, such as securities, the identity of the judge or decision facilitator is critical. Disputes important to the public require decisions by credible figures who are competent referees selected by an open process involving the public—the usual means of selecting judges. Arbitration could also be improved by fairness in discovery, record maintenance and appeal. These features offer the distinct advantages of neutral analysis of the case, equal access to discovery and application of clear legal standards as a basis for the findings.

The clear danger is that we might be replicating in arbitration some of the slower and costlier provisions of litigation. The SROs roundly reject the specter of losing their speed and informality. On the other side, arbitration reformers are not persuaded that even the acceptance of all of these suggestions would provide investors with sufficient protection. The measures proposed here steer a middle course and would restore public confidence in the securities arbitration process offered by SROs. These measures might impede to a minor degree the speed and procedural efficiency of arbitration. In the long run, however, increased investor confidence in the merits of arbitration should

228. Friedman, supra note 215, at 5.
229. Franklin, supra note 97, at 6.
230. Malcolm & Segall, supra note 9, at 757.
231. Franklin, supra note 97, at 6.
232. Brunet, supra note 104, at 44.
233. Franklin, supra note 97, at 6.
weigh favorably against minor delays occasioned by more vigilant oversight of the process.

IV. Conclusion

Arbitration ushers in concepts of minimalism for the settlement of disputes, and appeals to the current desire for more immediate, if not instant, results. On the other hand, modern discovery pursuant to the Federal Rules of Civil Procedure, representing both the best and worst aspects of trial without surprise, works hand-in-hand with the Federal Rules of Evidence to provide an extremely rational method of dispute resolution. Before such uniform rules of evidence and the even more recent emphasis on discovery, trials themselves were less information oriented. In early trials, even judicial authority figures played a more restricted role, helping the parties plead the issues but leaving the outcome to the inscrutable jury, which sometimes rendered verdicts beyond the apparent reach of reason, like the ancient ordeals and trials by battles. 234

Arbitration harks back to a much less heavily rational solution to disputes than the present-day trial. Although informality has replaced ancient ritual, certainty, speed and low cost characterize both ancient modes of proof and modern arbitration. While arbitration may only replicate in a different forum the history of the growth of trials from the ritualism of battle to the rationalism of a full-blown trial in a federal court, it may be that the widespread use of arbitration will prove as great a watershed as the rise of equity. Equity provided such innovative remedies as specific performance and injunctions, which the law later proved able to incorporate successfully. Eventually, new accommodations may be reached through the tension in our justice system produced by the rationalism of trials and the informality of arbitration.

For the immediate future, in the area of securities disputes, steering a middle course which incorporates some of the basic protections of the judicial system but which eschews massive discovery, rules of evidence and routine appeals will ensure the responsiveness of arbitration to the needs of investors, the securities industry and the general public. Even without innovative developments, such a fair and workable securities arbitration

system would achieve no small success through public acceptance.