



# Investors protection in the U.S.: the issue of mandatory arbitration clauses in contracts between investors and brokerage/ advisory firms

PROTEÇÃO DOS INVESTIDORES NOS ESTADOS UNIDOS DA AMÉRICA: A QUESTÃO DAS CLÁUSULAS DE ARBITRAGEM OBRIGATÓRIA EM CONTRATOS ENTRE INVESTIDORES E CORRETORAS DE VALORES/EMPRESAS DE ACONSELHAMENTO EM INVESTIMENTO

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## Abstract

This paper proposes a review of the American literature, as well as the main rulings of Supreme Court of United States, aiming to map the pros and cons of inserting a mandatory pre-dispute arbitration clause in contracts between investors and brokerage/advisory firms that trade on the securities market. The study discusses some proposals to banish this sort of clause and some ideas to reach a middle ground solution.

## Keywords

Arbitration; investors' protection; brokerage/advisory firms; securities market; adhesive contracts; consumers.

## Resumo

*O artigo propõe uma revisão da literatura americana e das principais decisões da Suprema Corte dos Estados Unidos, buscando mapear os prós e contras da inserção de cláusulas de arbitragem obrigatória em contratos firmados entre investidores individuais e empresas de corretagem atuantes no mercado de valores mobiliários. Discutem-se as propostas para banir tais cláusulas e algumas ideias de solução intermediária.*

## Palavras-chave

*Arbitragem; proteção dos investidores; corretoras de valores/empresas de aconselhamento em investimento; mercado de valores mobiliários; contrato de adesão; consumidores.*

## INTRODUCTION

The American literature on mandatory pre-dispute arbitration clauses in all sorts of contracts tends to present a clash between powerful and well organized corporations and fragile consumers, investors, and employees. Arbitration clauses ideally arise out party autonomy. Nevertheless, when one party inserts such clauses in an adhesive contract – preventing the counterparty to negotiate this provision – the arbitration becomes mandatory. The impossibility of choosing and the forceful waiver of the right to go to Court leave a bitter taste of unfairness on the customers' mouth.

Several proposals for an Arbitration Fairness Act (AFA),<sup>1</sup> which would amend the Federal Arbitration Act (FAA) addressed the matter by considering invalid any mandatory arbitration clauses in consumer, employment, franchise, and civil rights disputes. The idea is to curb the gap of sophistication and bargaining power between the parties (GROSS, 2010, p. 1175).

However, regardless of the fact that most customers of brokerage/advisory firms (investors) are in the same situation when dealing with broker-dealers and financial advisers, they were left out of the reach of the AFA draft presented in 2009. The latest version of the AFA bill, recently introduced by Senator Al Franken and Representative Hank Johnson to the American Congress in 2015, considers these investors as peers of plain consumers.

Nevertheless, nowadays, due to the lack of a legal provision banning, this sort of clause and pursuant to the consistent interpretation of the Courts (since the Supreme Court decision in *McMahon* in 1987), pre-dispute arbitration clauses inserted in securities transaction contracts are fully enforceable. The result is that the great majority of the securities firms include mandatory arbitration clause in their contracts (CFPB, 2013).

The Financial Regulatory Authority (FINRA) holds most of these mandatory arbitrations.<sup>2</sup> Although this non-profit independent entity was allegedly created to protect investors and regulate Broker Dealers and Advisory firms, some question its impartiality, adding to the lack of choice regarding arbitration itself the lack of choice on where the procedure will be held. These current features of pre-dispute arbitration clauses lead to a feeling that people related to the securities firms dominate the arbitration panels and, therefore, the decisions systematically harms the investors.

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1 One of these bills were introduced to American Congress in 2009; other in 2013 and then again in 2015. Apart from the most recent one (2015), the other never made out of the committee.

2 The Financial Regulatory Authority (FINRA) concentrate more than 90% of the arbitration involving securities transactions, describing their arbitration forum as “the largest securities dispute resolution forum in the United States, and has extensive experience in providing a fair, efficient and effective venue to handle a securities-related dispute”. Available at: <<http://www.finra.org/arbitration-and-mediation>>. Accessed: Mar. 31, 2015.

This perception of unfairness towards mandatory arbitration clauses is persistent among investors, at least in the last two decades. The financial crises of 2008 and the enactment of Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) in 2010 revived this debate. The act created a new regulatory authority, the Consumer Financial Protection Bureau (CFPB), and commanded this bureau to conduct a comprehensive study about the fairness of arbitration in different contexts, including securities transactions. The idea was to verify the viability of changing the legislation and prohibit mandatory arbitration clauses – and both the CFPB and the Securities Exchange Commission (SEC) are awarded by Dodd-Frank with the power to do so if they deem necessary.<sup>3</sup> In March 2015, CFPB turned in the final report of the aforementioned study. This means that, soon enough, we shall be able to see some regulatory efforts on this matter.

This paper will discuss the pros and cons of mandatory arbitration clauses in securities firms' contracts, taking into consideration a continuously evolving scenario, in which American Courts gradually started to foster arbitration as an alternative to traditional litigation and investors had become closer to consumers than to sophisticated agents of financial markets.

The first part will analyze the evolution of the legal background related to mandatory arbitration clauses, taking into account the legislative efforts to regulate it and the prominent cases on the matter, such as *Shearson v. McMahon* (1987) and *AT&T Mobility v. Conception* (2011). The second part will revise the pros and cons raised by the interested parties – securities industry and customers –, by organizations responsible to verify the efficiency of the system, and by legal scholars.

At the end, the study will try to identify future tendencies regarding this kind of clause, by creating a dialogue between the two opposite sides: customers' perceptions and empirical data gathered to measure efficiency of the dispute resolution system. The goal is to identify if there is truth to the most common customers' complaints and if there are grounds for a legislative change, prohibiting mandatory pre-dispute arbitration clauses in securities transactions.

## I LEGAL AND JUDICIAL BACKGROUND

The legal register of mandatory pre-dispute arbitration clauses was in the Federal Arbitration Act of 1926. It was part of a congressional agenda to favor arbitration in an environment where Courts saw arbitration as an inferior way to litigate controversial issues.<sup>4</sup> Regarding securities transactions, however, the posterior enactment of the Securities Act (1933) and

3 Dodd-Frank Wall Street Reform and Consumer Protection Act Section 1028 (a) on the regulatory power of CFPB to banish mandatory arbitration clauses and Section 921 on the power of SEC.

4 *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 511 (1944) and *Moses H. Cone*, 460 U.S. at 24. In *Scherk*, the claim arose from the breach of a contract that included a pre-dispute arbitration clause in the

the Securities Exchange Act (1934) created a legal conflict, once both acts give Federal and State Courts exclusive jurisdiction over claims arising under their provisions. More than that, these acts forbade the waiver of any of their provisions, among them, the judicial forum requirement to litigate securities issues (LINDERMAN, 1988, p. 333-334).

The Supreme Court tackled the conflict between the mandate of enforcement of pre-dispute arbitration clauses in the Arbitration Act and the judicial prevalence established by the securities related legislation in the following years. The jurisprudence evolved within time until present days.

The first emblematic case was *Wilko v. Swan*,<sup>5</sup> in 1953, where the Supreme Court decided if a pre-dispute arbitration clause in a contract between investor and brokerage firm was enforceable, once the claim was brought under the section 12(a) (2) of the Securities Act. In a judgment that exposed the negative opinion of the Court towards arbitration, the case was entered for the investor seeking to declare the arbitration clause void. The majority held that the Securities Act gave federal courts exclusive jurisdiction over claims arising under it, and prohibited the parties to waive this provision.<sup>6</sup>

The mood of the Supreme Court towards arbitrations, however, changed in the following decades. Maybe because of a series of political and social developments –such as the work overload of Courts –, pushing parties to alternative dispute resolution methods (ADR). In this new scenario, *Shearson/American Express inc. v. McMahon* (1987) was brought to the Supreme Court to discuss the enforceability of a pre-dispute arbitration clause in a contract between broker and customer, when the claim arose under Section 10b-5 of the Securities Exchange Act of 1934. Once again, the problem was the legal conflict between the Arbitration Act and the securities legislation, which favored the court system.<sup>7</sup> This time, however, the solution was completely different.

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international Chamber of Commerce in Paris, and the Court upheld the validity of the clause even if the claim involved violation of the section 10b-5 of the Securities Exchange Act, but refusing to overrule *Wilko* on the grounds that the “contract to purchase the business entities belonging to Scherk was a truly international agreement” which “involve[d] considerations and policies significantly different from those found controlling in *Wilko*.” 417 U.S. at 515.

5 *Wilko v. Swan*, 346 U.S. 427 (1953).

6 Section 12(a)(2) provides that any person who offers or sells a security through a prospectus or an oral communication containing a material misstatement or omission is liable to the purchaser for rescission of the purchase or damages – provided that the purchaser did not know about the misstatement or omission at the time of the purchase. The Supreme Court in *Wilko* listed some reasons why arbitration was inferior to litigation in that case, among them the lack of judicial review, arbitrators with no judicial training, procedure not suited for the material findings required in the case.

7 *Shearson/Am. Express v. McMahon*, 482 U.S. 220, 242 (1987).

In *McMahon*, which came to be known as the cornerstone of mandatory pre-dispute arbitration clauses in securities transactions, the opinion delivered by Judge O'Connor upheld the validity of the arbitration clause. The basis for this decision was that arbitration panels are an adequate forum to discuss matters related to the Securities Exchange Act, particularly Section 10b-5, and that *Wilko* did not apply to the case, once "that case should be read as barring the waiver of a judicial forum only where arbitration is inadequate to protect the substantive rights at issue". To consolidate the trend, in 1989, the Supreme Court judged *Rodrigues de Quijas v. Shearson/American Express Inc.*, which definitely overruled *Wilko* holding that claims arising under the Securities Act of 1933 can be subjected to arbitration too (BORN, 2014, p. 965).<sup>8</sup>

The outcome of these cases, and the fact that several passages of the opinion made clear that claims under securities legislation would be subject to arbitration in the presence of a pre-dispute arbitration clause, reverberated in the securities industry and began a process that led to the inclusion of pre-dispute arbitration clauses in the vast majority of contracts.<sup>9</sup> Moreover, it gave way to the creation of arbitration centers by the securities industry, such as the ones in the National Association Securities Dealers (NASD) and in the New York Stock Exchange (NYSE), which merged in 2007 to form the autonomous Financial Industry Regulatory Authority (FINRA), that comprises the largest arbitration forum for securities related claims (GROSS, 2010, p. 1177).

Nevertheless, the indiscriminate spread of mandatory arbitration clauses not only in securities contracts but in a number of other adhesive consumer agreements turned the congressional attention to the matter in the early 2000's. To the Congress, the broad interpretation given to the Federal Arbitration Act by the Supreme Court allowed mandatory arbitration clauses to bind parties with dramatically different levels of sophistication and bargaining power. The efforts to curtail this kind of behavior resulted in the proposal, coming from both the House of Representatives and the Senate, of the Arbitration Fairness Act (AFA) in 2009, prohibiting mandatory arbitration clauses in employment, consumer, franchise, and civil rights disputes.<sup>10</sup>

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<sup>8</sup> *Rodrigues de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 485 (1989).

<sup>9</sup> Findings from empirical research in the field points that most brokerage agreements include a provision of mandatory arbitration, such as the model of adhesion contract of Fidelity Investment, available at <[https://www.fidelity.com/bin-public/060\\_www\\_fidelity\\_com/documents/brokretagree.pdf](https://www.fidelity.com/bin-public/060_www_fidelity_com/documents/brokretagree.pdf)>. Regarding investor advisers' agreements, findings by the Massachusetts Securities division staff for 2013 states that almost half of the agreements contain such clauses, see Massachusetts Securities Division Staff (2013). Available at: <<http://www.sec.state.ma.us/sct/sctarbitration/Report%20on%20MA%20IAs%27%20Use%20of%20MPDACs.pdf>>. Accessed: Mar. 31, 2015.

<sup>10</sup> Arbitration Fairness Act of 2009, S.931, 111th Cong. (2009), H.R. 1020, Section 931 §2 (1). The Congress started discussing the possibility of amendment to the Federal Arbitration Act in 2005.

The AFA do not encompass, however, agreements between customers and securities firms, which would still fall under the courts idea that contracts “involving commerce” and, hence, would still have valid and enforceable arbitration clauses (GROSS, 2010, p. 1175). Because of that, and the fact that the profile of investors nowadays are much closer to consumer status than to sophisticated commercial parties,<sup>11</sup> regarding bargaining power and the inevitable submission to adhesive contracts, heated discussions surround the theme of mandatory pre-dispute arbitration clauses in securities transactions.

The theme is so controversial that, after the financial crisis of 2008, when a new wave of consumer protection regarding financial products arouse, the Dodd-Frank Wall Street Reform and Consumer Protection Act commanded the CFPB to study the perception of customers and the effectiveness of such clauses. Moreover, it empowered the new regulatory agency, along with the SEC, to prohibit or limit the use of mandatory arbitration clauses in securities contracts if such measure is deemed as necessary.

In 2015, a new draft for an Arbitration Fairness Act was presented to the American Congress equating the position of investors and consumers. This bill is still subject to the scrutiny of the congressional committee, which barred all previous proposals for an AFA.

The mandatory arbitration clauses are under attack in two fronts: (i) in Congress, with legislative proposals to amend the Federal Arbitration Act and prohibit or limit its use; and (ii) in the regulatory sphere, where the Congress empowered the CFPB and the SEC to prohibit or limit mandatory arbitration clauses in securities related contracts. Before considering if Congress or regulatory agencies should act to eliminate such clauses from securities related contracts, it is interesting to explore the pros and cons of these contractual provisions.

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In 2007, subcommittees from both the House and the Senate proposed the Arbitration Fairness Act with critics to the securities arbitration process noted in the hearings about the bill. In the wake of the financial crisis the matter of arbitration in financial industry were included in the Dodd-Frank Act, delegating to the SEC and to the CFPB the power to study and prohibit mandatory arbitration clauses – power which would be exercised by the Congress, if the AFA came to be enacted. See *The Arbitration Fairness Act of 2007: Hearing on S. 1782 Before de Subcomm. on the Constitution, 110<sup>th</sup> Congress (2007)*. Available at: <<http://www.gpo.gov/fdsys/pkg/CHRG-110shrg42605/pdf/CHRG-110shrg42605.pdf>>. Accessed: Apr. 1, 2015.

11 The treatment of investors as people with the same level of sophistication as consumers can be extracted from the content and design of the SEC website subdivision “investor.gov”, in which the Commission addresses to teachers, students, parents, military among other categories of people, and provides several tools for calculating investments, check the background of brokerage firms and so on.

## 2 PROS AND CONS OF THE MANDATORY PRE-DISPUTE ARBITRATION CLAUSES FOR CUSTOMERS OF SECURITIES FIRMS

The literature on pros and cons of mandatory pre-dispute arbitration clauses in securities transactions begins with *McMahon*, once this was the turning point of the Supreme Court holdings about the enforceability of such clauses in the context of securities related contracts and adhesion contracts (LINDERMAN, 1988, p. 337). It draws a picture of customers *versus* firms, in a David *versus* Goliath fashion.

Most of securities firms today include in its contracts a mandatory arbitration clause, taking the parties automatically to an arbitration panel held by an organization somehow connected to the securities market. They generally defend these clauses and these panels in terms of cost and speed, asserting that arbitration is not only fair to the parties but also less costly and faster than litigation. On the other hand, customers and investor protection organizations fight the mandatory clauses claiming they create an unbalance towards the securities firms. The lack of choice, as well as the lack of transparency of arbitration procedures, is in the center of most of the complaints.

### 2.1 PROS

Not only the securities firms, but also other entities of the financial market – such as banks (CFPB, 2013, p. 8) – fiercely defend mandatory pre-dispute arbitration clauses from the perspective of lowering the transactional costs of disputes between customers and securities firms. The defense of these clauses unfolds in two different aspects: (i) the superiority of arbitration over litigation; and (ii) the need for the clauses to be mandatory.

Regarding the first aspect, the defenders of mandatory pre-dispute arbitration clauses assert that arbitration is less costly for both parties and provides a faster solution, compared to litigation in federal and state courts regarding claims brought under the Securities Exchange Act of 1934 and under the Securities Act of 1933. The Financial Service Institute and The Financial Markets Practice Group of Briggs and Morgan P.A. delivered a comprehensive empirical research on the efficacy of securities arbitration, in response to the consumer protection legislative proposals that arose after the 2008 financial crisis (FSI; FMPG, 2010).

After surveying independent broker-dealers, the report concluded that arbitrations conducted by FINRA panels are more cost efficient than litigation, both regarding discovery and aggregate costs (FSI; FMPG, 2010, Appendix B), and generally reaches the merit hearing faster than courts reaches a final hearing or trial (SIFMA, 2007). According to the researchers, the perception of broker-dealers is consistent with previous Securities Industry and Financial Markets Association's (SIFMA) studies that compared the rate of cases that reached a final decision between 2006 and 2007. The SIFMA study reached the conclusion that arbitration is 40% faster, and costs, at least, US\$ 22.000 less than litigation (SIFMA, 2007, p. 3, 62). Consequently, arbitration would be the most appropriate way to

resolve small claims, and approximately 25% of the securities claims filed between 2006-2007 fell below a US\$10.000 threshold, a sum for which it is often not cost effective to litigate before Courts (GROSS; BLACK, 2008).

These entities affirm that one of the reasons for these benefits is a narrow tailored and specific focused discovery procedure, once this procedural phase is considered the most time and cost consuming part of litigation (FRIEDENTHAL; KANE; MILLER, 2013, p. 831-834). Besides, the arbitration procedure is fair and unbiased, once the FINRA provides an extensive list of safeguards on its Customer Code, and SEC really oversees the procedures (GROSS, 2010, p. 1190). The unfairness complaints would be a misperception of investors, probably because of the lack of choice.

The second aspect defenders of pre-dispute arbitration clauses enhance is the beneficial role of the mandatory character of these clauses. They contend that, although it may seem unpopular to deprive the customer of the choice whether or not to arbitrate a claim, providing this choice could lead to irrational decisions towards the default mechanism, which would be litigation (BARENDRECHT; DE VRIES, 2005, p. 93-111). Moreover, the possibility to resolve the matter in more than one way would compel the securities firms to adjust their business model to account the costs of litigation – costs that would ultimately be transferred to the customers (GROSS, 2010, p. 1190).

Finally, enthusiasts of such clauses hold that arbitration in the securities field is fundamentally different – and better – than arbitration in general consumer and employment fields, which are directly addressed by the prospective AFAs (GROSS, 2008, p. 101-107). The existence of an administrative agency to review rules, procedures, and protocols (SEC) makes securities arbitration superior to other kinds of consumer arbitration, in which there is no supervisory authority. Moreover, FINRA's Code of Arbitration Procedure for Customers Disputes include a number of provisions that are not present in the mandatory arbitration situations target by AFA bill of 2009<sup>12</sup> and should enhance the fairness aspect. Some of these provisions are the required notice, hearing in a convenient location, and the composition of the panel.

Especially regarding the choice of arbitrators, which is one of the focuses of mandatory arbitration critics, FINRA's Code provides multiple possibilities of panel. There can be a one-arbitrator panel – integrated by a public arbitrator – for claims below US\$ 50,000.00 and a three arbitrators panel in cases above this threshold, integrated by one public arbitrator, one non-public arbitrator and one chairperson roster. According to FINRA's this blend is enough to ensure an unbiased composition of the panel, once necessarily one arbitrator cannot have any ties to the industry.

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12 CUSTOMER CODE R. 12300, 12301, 12600, 12213, 12400, 12408, 12414.



Besides, from a systemic point of view, enthusiasts of the mandatory pre-dispute arbitration clause contend that eliminating the mandatory character would diminish the political pressure over FINRA and SEC to ensure the fairness of the procedure, what could harm the whole arbitration system (GROSS, 2010, p. 1193).

## 2.2 CONS

In the opposite corner, investors perceive the mandatory clauses as fundamentally unfair, from both the procedural and the systemic points of view. They believe that arbitration panels are predominantly dominated by the securities industry, and perceive that this influences the whole procedure – from the fairness of the decision to the costs of the dispute (CFPB, 2013, p. 7). Regarding that, investors' protection entities (such as NASAA) contest the affirmation that arbitration is more cost efficient in all cases (NASAA, 2013).

When it comes to procedural features, investors do not see arbitration as a superior mechanism compared to litigation. The idea of a narrow tailored discovery phase is perceived as a limitation harmful to the party that does not master the subject-matter – in securities cases, the customers (LINDERMAN, 1988, p. 342). Moreover, there is no right to appeal (GROSS, 2010, p. 1193). Other problem frequently pointed is the lack of transparency, once the arbitration panels are not required to explain the reasons for the decision or the ratio they used to calculate the damages and, in some cases, they are not even required to issue a writing decision (GROSS; BLACK, 2008, p. 39). Apart from the bad feeling of being left with no explanation of the outcome of the case, the lack of written opinions diminishes the accountability of the arbitration panels, may impair judicial review when procedural mistakes occur, and prevent the formation of precedents.<sup>13</sup>

One of the most contentious points regarding securities arbitration is the fact that most arbitration panels are believed to be predominantly connected to the securities industry. As pointed out before, the Financial Industry Regulatory Authority (FINRA) operates the preferable and largest arbitration forum for securities matters. The composition of the panels can also lead to a predominance of people tied to the securities industry, once the participation of a “non-public” arbitrator is required in the three-member panel. These professionals are generally members of the securities industry. Besides that, it is the FINRA and the Self-Regulatory Organization (SRO) who define the qualified professionals that can integrate the arbitrator pool – including the public arbitrators and chairpersons (NASAA, 2009). Considering these facts, it would be impossible to ensure an unbiased composition of the

13 Justice Blackmun noted on his dissent in *McMahon* that “Arbitrators are not bound by precedent and are actually discouraged by their association from giving reasons for a decision” in *Shearson/Am. Express v. McMahon*, 482 U.S. 220, 242 (1987), p. 2354.

panel (GROSS; BLACK, 2008, p. 24-25; LINDERMAN, 1988, p. 344-345) and as the arbitration is mandatory, it is also difficult to ensure a fair decision.

From a more systematic point of view, the fact that customers are submitted to adhesive contracts containing the pre-dispute mandatory arbitration clause, and that the great majority of securities firms include this sort of clause in its contracts, completely restrains the customer's bargaining power. It is not only a matter of lack of knowledge or information, it is the fact that these are "take it or leave it" propositions that are present in most contracts of this financial segment. In other words, if you want to trade in the market, you must submit to this provision. It curbs the bargaining power not only from customers, but also from other firms of the financial market (DONEY, 2010, p. 236-238).

The literature raises yet another concern. Compelling the use of arbitration, the securities industry is able to diminish the aggregation of claims and the litigation of securities issues – such as securities fraud – through class actions. This can be pointed out as one of the goals of mandatory arbitration clauses. Nowadays, some broker-dealer and advisor contracts contain also a class action waiver clause – through which the customer waives the right of taking part in any class action discussing the security transaction (STERN-LIGHT, 2012, p. 89-90). In addition, FINRA's arbitration panels cannot entertain class claims, according to the Section 12204 (a) of the Arbitration Customers' Code. The Supreme Court recently upheld the validity of the so-called "no-class" provision in *AT&T Mobility LLC v. Conception*.<sup>14</sup>

Critics of the mandatory arbitration consider that the joint interpretation of these mandatory arbitration clauses and "no-class" provision gives the securities industry absolute control over disputes with investors. First, because a large number of claims under securities laws are quite small, and the incentives to litigate – or even to arbitrate – such claims individually are very low, once the costs will probably surpass the benefits. An outcome of this unbalance of incentives is that there would be no individual private enforcement of liability rules of any sort, undermining the deterrence effect of litigation, which is one of the most important features of small claims class actions (CFPB, 2013, p. 5; RUBENSTEIN, 2006, p. 721).

Finally, critics of the mandatory arbitration clauses contest the affirmation that arbitration is clearly more cost effective than litigation, especially regarding small claims. Arbitration fees – and the unclear way they are divided between the parties even when the investor receives an award – are significant and can undermine real compensation. Furthermore, the fact that arbitration is mandatory and that FINRA is practically a monopolist player as arbitration *fori*, it could manipulate the costs of the procedure. For instance, in the

14 *AT&T Mobility v. Conception*, 131 S. Ct. 1740, 1753 (2011).

end of 2014, FINRA filed with the SEC a proposed rule change to increase some of the arbitration costs in its panels (FINRA, 2014).

The perception of the customers regarding the cost efficiency of arbitration does not coincide with the view of securities industry. In fact, the empirical research conducted by Gross and Black (2008, p. 27-41) on the fairness of securities arbitration noted that 49,13% of the researched customers of securities firms considered the arbitration process too expensive.

### 3 LOOKING TO THE FUTURE — BANNING MANDATORY ARBITRATION CLAUSES OR MEETING HALFWAY?

After years of discussion, both the critics and the defenders of mandatory pre-dispute arbitration clauses agree that securities arbitration, as we know it, will endure some structural changes soon (GROSS, 2010, p. 1194). After the Dodd-Frank Wall Street Reform and Consumer Protection Act empowered the CFPB and the SEC to prohibit or limit the use of mandatory arbitration clauses in securities contracts, the investors' protection entities intensified the efforts to secure the ban of such clauses. On the other hand, securities firms and FINRA seem ready to commit to changes on the structure of the mandatory clauses and arbitration procedures to avoid a statutory prohibition (GROSS, 2010, p. 1185-1187).

Congressman Keith Ellison introduced a bill to the House of Representatives in 2013 called "The Investors Choice Act". The goal of the new act would be to prohibit mandatory arbitration clauses in contracts between securities firms and customers, as well as ban any clause that would prevent the investor to seek court relief individually or as a member or representative of a class.<sup>15</sup> This proposal is quite straightforward on the banning of such clauses, leaving no space to discuss middle ground solutions such as modifications on the rules to choose panels and their components.

The investors' protection entities strongly support the bill asserting that, if enacted, the "The Investors Choice Act" would fill in the blank left by the ongoing inaction of SEC and the CFPB — once six years after the enactment of Dodd-Frank, the commission had not

<sup>15</sup> The summary of the bill states that the new act "Declares unlawful for a broker, dealer, funding portal, or municipal securities dealer (entities) to enter into, modify, or extend an agreement with customers or clients governing a future dispute between the parties that would mandate arbitration. Declares likewise unlawful acts by such entities that would restrict, limit, or condition the ability of a customer or client to: (1) select or designate a forum for dispute resolution, or (2) pursue a claim relating to a dispute in an individual or representative capacity or on a class action or consolidated basis." Available at: <<https://www.congress.gov/bill/113th-congress/house-bill/2998>>. Accessed: Mar. 28, 2015.

undertaken a comprehensive regulatory review of mandatory pre-dispute arbitration clauses (ABSHURE, 2013). Their position, as well as the bill's momentum, seems to be strengthened by the fact that the final draft of the "Arbitration Study" turned in by the CFPB to the Congress focused on pre-dispute arbitration clauses in other financial contracts – such as credit card and loans – and left out the securities transaction (CFPB, 2015).

The detractors of mandatory pre-arbitration clauses fiercely defend the ban of any kind of arbitration clause. However, we envision some possible middle grounds to protect customers and, yet, keep arbitration for causes involving higher stakes. One of the possible proposals is a "carve-out" provision in case of small claims. According to the CFPB's study, regarding other financial products such as students' loans contracts, most arbitration clauses provide an opt-out possibility for claims that can be adjudicated on small claims courts (CFPB, 2015).<sup>16</sup> This model of opt out could be inserted in contracts of the securities firms, even in cases where the mandatory arbitration clause is present, providing customers with the possibility of pursuing small claims in the courts system. Another idea that also focuses on the adjudication of small claims would be directing the regulatory efforts on banning "no-class provisions", aiming to preserve the possibility of aggregate litigation of securities related claims and the social benefits that arouse from it.

The securities industry seems to be more interested in proposing middle ground solutions to the problem, once they have interest in keeping its current position, avoiding radical banning proposals.

In addition to the ongoing lobby to avoid the Arbitration Fairness Act to be extended to securities transactions, as well as to keep away the ban threat after Dodd-Frank, the securities industry also responded to the crisis of 2008 by adapting several rules of FINRA's Code of Arbitration Procedures for Customers Disputes. These changes intend to modify customers' perception of unfairness by (i) prohibiting pre-dispute arbitration clauses to encompass class-action waiver provisions; (ii) requiring the arbitration panel to write an explain decision awarding damages; and (iii) imposing sanction for discovery intransigence.<sup>17</sup>

In 2013, FINRA amended the Code of Arbitration Procedures for Customers Disputes once more, aiming to address customers concerns on regarding the composition of arbitra-

<sup>16</sup> As much as this provision seems to be favor to consumers, once they would probably be best served on the court system than in arbitration panels – in terms of transparency and impartiality – the CFPB study concludes, surprisingly, that most litigation in small claims courts regarding financial issues are business-initiated (approximately 53%). Therefore, the financial industry tends to use carve-out provisions and the small claims courts more frequently than consumers.

<sup>17</sup> Several Sections of FINRA's Customer Code were amended in the beginning of the crises period and in at the same time the AFA proposals reached the Congress. One of them was the section 12904 (j) about the need for written opinions and detailed damage awards.

tion panels, especially regarding the method to select these panels. Before the amendment, in cases with a three arbitrators' panel, FINRA provided customers with a choice between two panel-composition methods: (i) a mixed panel of one chair-qualified public arbitrator, one public arbitrator and one non-public arbitrator; (ii) the All-Public Panel Option, in which the party can select an arbitration panel consisting of three public arbitrators. The default option was the all-public arbitrators' panel. After the amendment, there is only one method, which includes the selection of the panel from 3 lists – one with 10 chair-qualified public arbitrators, one with 10 public arbitrators, and one with 10 non-public arbitrators. The motivation for the change was to simplify the procedure and to call the attention of consumers to the importance of a proactive and participative choice of the panel (FINRA, 2013).

These changes would address part of the concerns demonstrated by investors regarding mandatory arbitration clauses, but some of them – particularly important ones – remain unaddressed. It is the case of the arbitration panel selection, once the arbitrators – both public and non-public – are selected from a list that although receives the name of “neutral list” is kept and controlled by FINRA (LINDERMAN, 1988, p. 345). Other important concern is that only decisions that award damages need to be written and explained, leaving out of the Customers Code scope decisions entered against the customers. That may enhance the transparency regarding a range of damages in different cases arbitrated by the arbitration panels, but prevents the effective construction of a system of precedents.

The fact that the Consumer Financial Protection Bureau (CFPB) has not addressed specifically the issue of securities transactions in the study about mandatory pre-arbitration clauses required by the Dodd-Frank Act, will leave the matter with no definitive answer. Nevertheless, it seems clear that the financial crisis of 2008 substantially changed the environment that upheld the validity of such clauses since the *McMahon* ruling in 1987.

## CONCLUSION

The discussion over the maintenance or the ban of mandatory pre-arbitration clauses in contracts between investor and securities firms is far from over. Revising the literature about the topic, the main characteristic is that defenders and detractors of the mandatory arbitration clause have a hard time meeting halfway. Either the investors' protection entities preach about an inalienable right to choose, or the securities industry threatens a price increase in case of banishment of such clauses.

In our opinion the current model, that indiscriminately allows the mandatory clauses, have two fundamental flaws. First, it transforms in mandatory something that was born as an alternative way to solve disputes and that draws its legitimacy from consensus (LINDERMAN, 1988, p. 333). Furthermore, it is based on a misperception of the profile of customers of brokerage and advisory firms and the level of information they have about the financial

operations they are engaging in. They are ultimately consumers of financial industry services and, as such, should receive the same level of legal protection of consumers in general – therefore, being protected by provisions that prohibit the mandatory arbitration clauses.

That does not mean arbitration is doomed to fall into oblivion in securities related transactions. We believe the customers' choice must be respected and arbitration should be elective, but there are several ways to present both choices – litigation and arbitration – to investors. The simpler one would be negotiate arbitration in a separate contract, allowing the customer to opt-in. This is the model adopted by countries like Brazil (MARQUES, 2004, p. 635). A possible critic to this option is that it could benefit inertia and force investors to litigation, which is the legal “default” option (GROSS, 2010, 1191). As an alternative, regulators could make use of the nudge theory, changing the default option to arbitration and allowing customers to opt-out and take their claims to Court (THALER; SUNSTEIN, 2008; WILLIS, 2013, p. 1155). If the arbitration is, as preached, so superior to litigation, within time it will become the preferable choice.

Assuming a position after discussing the pros and cons on this issue, customers' choice must be respected and mandatory arbitration clauses should not be permitted in securities related contracts. That does not mean regulatory authorities such as SEC and CFPB should not take other measures to foster arbitration, such as inverting the default rule that seems to favor litigation, as proposed above. These remedies could enhance the investors' perception of fairness regarding arbitration in securities related transactions, as well as keep the cost and time efficiency of the system.

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