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SECURITIES ARBITRATION: RESOLUTION OF DISPUTES BETWEEN SECURITIES BROKERS AND THEIR CUSTOMERS

I. INTRODUCTION

*Wilko v. Swan*¹ declared the Supreme Court's unwillingness to enforce predispute agreements to arbitrate claims arising from violations of the Securities Act of 1933,² evidencing their mistrust of the system of arbitration.³ Over nearly four decades, the holding of *Wilko* has been slowly eroded,⁴ creating uncertainty as to the enforceability of arbitration agreements between brokers and their clients. Now, however, arbitrating the disputes that arise from the relationship between a securities broker and their clients is no longer subject to uncertainty where there has been a predispute agreement to arbitrate. In its recent decision in *Rodriguez De Quijas v. Shearson/American Express*,⁵ the Supreme Court held that such agreements to arbitrate disputes arising under the Securities Act of 1933 are enforceable, expressly overruling *Wilko v. Swan*.⁶

This comment will explore the arbitration of securities disputes between securities brokers and their customers, showing

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

2. Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77mm(1988)).

3. See *Wilko*, 346 U.S. at 435-36. The Court stated "[the] effectiveness [of the Securities Act] in application is lessened in arbitration as compared to judicial proceedings." *Id.* See also, *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 233 (1987).

4. For a discussion of cases that led up to the Supreme Court's overruling of *Wilko*, see *infra* notes 36-67 and accompanying text. See also, Bedell & Bosch, *The Rodriguez Decision: A New Tradition In The Arbitration of Securities Disputes*, 18 SEC. REG. L.J. 53 (1990); Malcolm & Segall, *The Arbitrability of Claims Arising Under Section 10(b) of the Securities Exchange Act: Should Wilko Be Extended?*, 50 ALB. L.R. 725 (1986).

5. *Rodriguez De Quijas v. Shearson/American Express Inc.*, 109 S. Ct. 1917 (1989).

6. *Id.* at 1922.

that the investor today is fully protected in an arbitral forum and that the advantages to the investor who arbitrates a claim against their broker are expansive.

The comment will begin with a brief overview of the three major components⁷ which the courts have struggled with in an effort to reconcile and harmonize with one another. The first component is The Arbitration Act of 1925⁸ which expressed the legislature's intent to recognize and codify the viability of arbitration as an alternative to settling disputes in a forum other than a judicial one. The other two components of this trilogy are the Securities Act of 1933⁹ and the Securities Exchange Act of 1934¹⁰ which were intended to provide protection for buyers of securities when dealing with sellers, with whom they may not be dealing at arms length.¹¹ From *Wilko* to *Rodriguez De Quijas*, there is a rich judicial history which traces the evolution of arbitrating disputes between securities brokers and their clients, showing the interrelationship of the three Acts, and the problems that the court has had in trying to reconcile them.

The comment will then examine the actual predispute agreements to arbitrate contained within customer agreements and the extent of the claims that are covered, including Securities Act and Securities Exchange Act violations and the Racketeer Influenced and Corrupt Organizations Act (RICO).¹² This section of the comment will also look at how the standard defenses of fraud, duress, and misrepresentation affect predispute arbitration agreements.¹³

7. Securities Act of 1933, Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified at 15 U.S.C. §§ 78a-78kk (1988)) and the Federal Arbitration Act of 1925, Pub. L. No. 68-401, 43 Stat. 883 (codified as amended at 9 U.S.C. §§ 1-14 (1982)). See *infra* sec. II and notes 11-31.

8. Federal Arbitration Act of 1925, Pub. L. No. 68-401, 43 Stat. 883 (codified as amended at 9 U.S.C. §§ 1-14 (1982)).

9. Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified at 15 U.S.C. §§ 77a-77mm (1988)).

10. Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified at 15 U.S.C. §§ 78a-78kk (1988)).

11. See *Wilko*, 346 U.S. at 435. "While a buyer and seller of securities, under some circumstances, may deal at arms's length on equal terms, it is clear that the Securities Act was drafted with an eye to the disadvantages under which buyers labor." *Id.* at 435.

12. Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1962, 1964 (1988).

13. See *infra* notes 90-98 and accompanying text.

The comment will conclude that with the uncertainty of the enforceability of arbitration clauses contained within customer agreements resolved,¹⁴ the advantages of arbitration will outweigh the disadvantages and provide for more adequate and efficient resolution of disputes between securities brokers and their clients. In *Rodriguez De Quijas*, the Supreme Court correctly recognized the important advantages of arbitrating securities disputes between brokers and their clients,¹⁵ and thereby finally recognized and harmonized the legislative schemes of the Securities Acts and the Arbitration Act.

II. HISTORICAL OVERVIEW

A. THE FEDERAL ARBITRATION ACT OF 1925

Understanding the motivation and intent of the legislature in enacting the Federal Arbitration Act of 1925¹⁶ (FAA) is essential in order to see how and why the courts finally overruled the incorrect decision of *Wilko*.¹⁷ Congress clearly saw the need to put arbitration agreements "upon the same footing as other contracts, where it belongs."¹⁸ In acting on this need, Congress evidenced its primary intent in passing the statute, to enable persons to enforce agreements to arbitrate to which they are a party.¹⁹ Congress was also aware of the many benefits that would accompany the passage of the FAA,²⁰ including saving the time and expense involved in litigation, realizing that the FAA would alleviate some of these problems.²¹

14. See *Rodriguez*, 109 S. Ct. at 1922; *McMahon*, 482 U.S. at 242.

15. See *infra* notes 100-122 and accompanying text.

16. See *Dean Witter Reynolds v. Byrd*, 470 U.S. 213, 220 (1985) (quoting H.R. REP. No. 96, 68th Cong., 1st Sess. 2 (1924)); see also *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, 460 U.S. 1, 24 (1983).

17. *Rodriguez*, 109 S. Ct. at 1922 (1989). The Court stated: "We now conclude that *Wilko* was incorrectly decided and is inconsistent with the prevailing uniform construction of other federal statutes governing arbitration agreements in the setting of business transactions." *Id.* See also *infra* note 66.

18. *Dean Witter Reynolds v. Byrd*, 470 U.S. at 219 (1985) (quoting H.R. REP. No. 96, 68th Cong., 1st Sess. 1 1924)).

19. *Id.* at 220. The court in *Byrd* also rejected the suggestion that the overriding goal of the Arbitration Act was to promote the expeditious resolution of claims, noting that the "purpose behind its passage was to ensure judicial enforcement of privately made agreements to arbitrate". *Id.* at 219.

20. *Id.* at 220.

21. The House Report observed: "It is practically appropriate that the action should be taken at this time when there is so much agitation against the costliness and delays of

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Regardless of what Congress envisioned and intended in the passage of the FAA, the court in *Wilko* displayed suspicion of the arbitration process as "a method of weakening the protections afforded by the substantive law to would be complainents. . . ." ²² After *Wilko*, this "old judicial hostility to arbitration" ²³ began to disappear, the mistrust of arbitration as an alternative form of dispute resolution eroded, and the courts began adhering to the legislative intent of the FAA. The courts began to recognize the "liberal federal policy favoring arbitration agreements" ²⁴ and subsequently declared that it must "rigorously enforce agreements to arbitrate." ²⁵ Thus, a trend of favoring the enforcement of predispute arbitration agreements in securities disputes began gaining momentum soon after *Wilko* was decided and has continued up through *Rodriguez*.

With their rigorous enforcement of the spirit and intent of the FAA, the courts have remained faithful to Congress's mandate by restraining hostile impulses against the arbitration of securities disputes and enforcement of predispute agreements to arbitrate. ²⁶

B. THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934

Congress saw the need to pass legislation, in the wake of the stock market crash in 1929 and an ailing economy, that would afford protections to investors and assist in healing this country's troubled and depressed economy. ²⁷ They passed the Securi-

litigation. These matters can be largely eliminated by agreements for arbitration, if arbitration agreements made valid and enforceable." HR REP. No. 96, 68th Cong., 1st Sess., 2 (1924).

22. *Rodriguez De Quijas*, 109 S. Ct. at 1920. "[*Wilko's* suspicion of arbitration] has fallen far out of step with our current strong endorsement of the federal statutes favoring this method of resolving disputes." *Id.*

23. *Rodriguez De Quijas*, 109 S. Ct. at 1920, quoting *Kulukundis Shipping Co. v. Amtorg Trading Corp.*, 126 F.2d 978, 985 (2d Cir. 1942).

24. *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, 460 U.S. at 24; see also *supra* note 11.

25. *Dean Witter Reynolds v. Byrd*, 470 U.S. at 221.

26. See e.g., *Rodriguez De Quijas*, 109 S. Ct. at 1920; *Securities Industry Assn. v. Connolly*, 883 F.2d 1114 (1st Cir. 1989).

27. See *United States v. Naftalin*, 441 U.S. 768, 775 (1979) ("[T]he Act emerged as part of the aftermath of the market crash in 1929. . . Congress' primary contemplation was that regulation of the securities markets might help set the economy on the road to

ties Act of 1933 and the Securities Exchange Act of 1934 in hopes of accomplishing these ends.²⁸

The purposes of the two Acts were to prevent fraud in the interstate offer or sale of securities,²⁹ heal the economy,³⁰ require securities dealers to fully disclose transactional information, and to protect against market manipulation.³¹ The two acts were meant to be complimentary of each other and the courts have tried to construe them harmoniously.³²

Each Act contains a major provision which constitutes the majority of claims that are involved in disputes between brokers and their clients. Section 12(2) of the Securities Act³³ requires the full disclosure of material information concerning the offer or sales of securities by a broker, providing investors with a remedy for any violation of this section.

recovery."); See also Malcolm & Segall, *The Arbitrability of Claims Arising Under Section 10(b) of the Securities Exchange Act: Should Wilko Be Extended?*, 50 ALB. L.REV. 725 (1987).

28. See *supra* notes 2 and 11.

29. See S. REP. NO. 47. 73d Cong., 1st Sess. 1 (1933). "The purpose of this bill is to protect the investing public and honest business. . . . The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; to restore the confidence of the prospective investor in his ability to select sound securities; to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power." *Id.*

30. See *United States v. Naftalin*, 441 U.S. 768, 775 (1979)(referring to the remarks made by Reps. Kelly and Chapman and Sen. Norbeck in 77 CONG. REC. at 2925, 2935, and 3232 (1933)).

31. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) ("The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of stock transactions. . ."); See also Note, *Mixed Arbitrable and Nonarbitrable Claims in Securities Litigation: Dean Witter Reynolds v. Byrd*, 34 CATH. U.L.REV. 525, 533 n.52 (1985).

32. *Rodriguez De Quijas*, 109 S. Ct. at 1922. The Court stated that: "[T]he 1933 and 1934 Acts should be construed harmoniously because they constitute interrelated components of the federal regulatory scheme governing transactions in securities." *Id.* quoting in part *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206 (1976). The Court further stated that: "[T]he inconsistency between *Wilko* and *McMahon* undermines the essential rationale for a harmonious construction of the two statutes (1933 and 1934 Acts), which is to discourage litigants from manipulating their allegations merely to cast their claims under one of the securities laws rather than another." *Rodriguez*, 109 S. Ct. at 1922.

33. Securities Act of 1933 section 12(2) (codified at 15 U.S.C. section 771 (1985)).

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Section 10(b) of the Securities Exchange Act³⁴ is broad in its scope. Essentially, it is an anti-fraud provision that not only covers misrepresentation and omissions, but also failure to disclose and false statements made to buyers of securities.³⁵

C. THE COURT'S BATTLE WITH RECONCILING THE THREE ACTS

The Supreme Court found that the two policies expressed by the Securities Acts and the Arbitration Act were seemingly at odds with each other. On the one hand, the Arbitration Act provided a means for "prompt, economical, and adequate solution of controversies through arbitration. . . ."³⁶ While on the other hand, Congress sought to protect the rights of investors with their passage of the 1933 and 1934 Securities Acts, forbidding waiver of any of those rights.³⁷

Commentators and the Court have recognized the tension that has existed between the Federal Arbitration Act and the Securities Acts.³⁸

*Wilko v. Swan*³⁹ provided the Supreme Court with its first opportunity to try and reconcile and harmonize the Federal Arbitration Act and the Securities Act of 1933. The court in *Wilko* was faced with deciding whether or not a claim brought under

34. Securities Exchange Act of 1934 section 10(b) (codified at 15 U.S.C. § 78j (1988)) and S.E.C. Rule 10(b)(5) (codified at 17 C.F.R. § 240.105-b (1989)).

35. See S.E.C. Rule 10b(5) (codified at 17 C.F.R. § 240.10b-5 (1989)). The S.E.C. enacted Rule 10b(5) pursuant to the power it has under the Securities Exchange Act of 1934, which created the S.E.C. 15 U.S.C. § 78w(a)(1) (1982). Rule 10b(5) provides in part: "It shall be unlawful for any person. . .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."

36. *Wilko*, 346 U.S. at 438.

37. *Id.*

38. See Malcolm & Segall, *supra* note 4 at 726 (conflict between the two policies creates the problem addressed by the article).

39. In *Wilko*, an investor brought suit against an investment firm claiming that they had falsely represented the value of some stock that was purchased. The investor brought his claim under section 12(2) of the Securities Act of 1933. A contract between the investment firm and the customer contained an agreement to arbitrate. The investment firm sought to stay the trial pending arbitration. The district court denied the stay and the Court of appeals reversed the district court. See *Wilko v. Swan*, 107 F. Supp. 75 (S.D.N.Y. 1952), *rev'd*, 201 F.2d 439 (2d Cir. 1952), *rev'd*, 346 U.S. 427 (1953).

section 12(2) of the Securities Act by an investor was arbitrable where a valid agreement had been signed to do so. The court stated that section 14 of the Securities Act, which voids any agreement or stipulation waiving any provision of the Act,⁴⁰ prevented the enforcement of predispute agreements to arbitrate. In its decision, the court declared that predispute agreements to arbitrate claims arising under Securities Act section 12(2) were not enforceable.⁴¹

In its analysis, the court felt that the congressional purpose⁴² and mandate of the Securities Act overrode those contained in the Federal Arbitration Act.⁴³ Clearly, the court felt that the arbitral system, as it existed in 1953, was inadequate to sufficiently protect investors.⁴⁴ In light of these perceived inadequacies,⁴⁵ the court felt that 12(2) claims “require the exercise of judicial direction to fairly assure their effectiveness.”⁴⁶

In post-Wilko decisions, the Supreme Court was again faced with trying to reconcile conflicts between the Securities Act, Exchange Act, and the Arbitration Act. In *Scherk v. Alberto Culver*,⁴⁷ the enforcement of an arbitration clause was at issue for a claimed violation of section 10(b) of the Securities Exchange Act. The arbitration clause was contained in an agreement be-

40. Securities Act of 1933 § 14. Section 14 states that “any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void.” 15 U.S.C. § 77n.

41. *Wilko*, 346 U.S. 427 (1953). The court in *Wilko* limited its holding to agreements made prior to the existence of a controversy. *See id.* at 438 (Jackson, J., concurring). The courts have uniformly held that *Wilko* doesn’t apply to agreements to arbitrate existing disputes. *See e.g.*, *Tullis v. Kohlmeyer & Co.*, 551 F.2d 632, 637 (5th Cir. 1977); *Coenen v. R.W. Pressprich & Co.*, 453 F.2d 1209, 1213 (2d Cir. 1972), *cert. denied*, 406 U.S. 949 (1972); *Gardner v. Shearson, Hammill & Co.*, 433 F.2d 367 (5th Cir. 1970).

42. *See supra* note 16 and accompanying text.

43. 346 U.S. at 438.

44. The court in *Wilko* discussed a number of these inadequacies. The Court expressed concern over the fact that arbitrators must make legal determinations “without judicial instruction on the law” and that the award can be made without a recorded reason. Thus, judicial review for error in the arbitrators decision would be virtually non-existent. The court also felt that arbitration was unsuitable for cases requiring “subjective findings on the purpose and knowledge of an alleged violator”. *See* 346 U.S. at 435-37; *see also McMahon* 482 U.S. at 231.

45. *Id.*

46. 346 U.S. at 437.

47. *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974).

tween an American company and a German company.⁴⁸ In deciding whether or not the agreement to arbitrate should be enforced the Court looked to the particular circumstances of the case.⁴⁹ Important to their decision was the fact that the contract in question was truly international in context, involving an American corporation, a German citizen, and the sales of businesses organized under the laws of European countries.⁵⁰ In light of the international commercial context⁵¹ of the agreement, the court upheld the predispute agreement to arbitrate.⁵² The court made a strong suggestion that *Wilko* might not be applicable to claims arising under the 1934 Act.⁵³

The Supreme Court was again confronted with the arbitrability of section 10(b) claims in *Dean Witter Reynolds v. Byrd*⁵⁴ and the arbitrability of federal antitrust claims in *Mitsubishi v. Soler Chrysler-Plymouth*.⁵⁵ The issue before the court in *Byrd* was whether or not arbitration should be compelled where both section 10(b) and pendant state law claims were involved.⁵⁶ The Supreme Court, in reversing the lower courts, ruled affirmatively on this issue, relying on the language and the legislative history of the Federal Arbitration Act.⁵⁷ The Court stated that where a case contains both arbitrable and non-arbitrable claims, arbitration of the pendant arbitrable claims must

48. *Id.*

49. *See Scherk*, 417 U.S. at 515.

50. *Id.*

51. The court in *Scherk* placed a great emphasis on the fact that the case was in an international setting. The court felt that a failure to uphold the agreement "would surely damage the fabric of international commerce and trade, and imperil the willingness and ability of businessmen to enter into international agreement." *Id.* at 516. *See also McMahon*, 482 U.S. at 255, n.11 (Justice Blackmun concurring and dissenting with Justices Brennan and Marshall).

52. *See Scherk*, 417 U.S. at 519-20.

53. The court stated: "A colorable argument could be made that even the semantic reasoning of the *Wilko* opinion does not control the case before us. There is no statutory counterpart of section 12(2) in the Securities Exchange Act of 1934, and neither section 10(b) . . . nor Rule 10 b-5 speaks of a private remedy. . . ." *Id.* at 513.

54. *Dean Witter Reynolds v. Byrd*, 470 U.S. 213 (1985).

55. *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614 (1985).

56. *See Dean Witter Reynolds v. Byrd*, 470 U.S. at 215.

57. *Id.* at 218. The Court, in determining whether the District Court should compel arbitration, looked to the Arbitration Act's language ("[I]nsofar as the language of the Act guides our disposition of this case, we would conclude that agreements to arbitrate must be enforced. . . .") and the Act's legislative history ("The legislative history of the Act establishes that the purpose behind its passage was to ensure judicial enforcement of privately made agreements to arbitrate.") *Id.* at 219.

be compelled, “. . . even where the result would be the possibly inefficient maintenance of separate proceedings in different forums.”⁵⁸ Although the court did not rule directly on the applicability of *Wilko* to Exchange Act claims, the decision did provide further support for the enforcement of predispute agreements to arbitrate.

In *Mitsubishi*,⁵⁹ the arbitrability of a claim under federal antitrust law in an international commercial setting was at issue.⁶⁰ The Court reasoned that a bifurcated process was necessary in determining whether or not arbitration clauses should be enforced.⁶¹ The first step was to determine if the agreement encompassed statutory issues and secondly, consider whether any legal constraints, external to the agreement of the parties, prohibited the arbitration of those issues.⁶² The court again displayed its strong support of the FAA citing that “[q]uestions of arbitrability must be addressed with a healthy regard for the federal policy favoring arbitration. . . .”⁶³

The decisions in *Scherk*, *Byrd*, and *Mitsubishi* led to the inevitable decision by the Supreme Court in *McMahon* that predispute agreements to arbitrate claims under section 10(b) of the Securities Exchange Act were enforceable.⁶⁴ The recent decision by the court in *Rodriguez De Quijas v. Shearson/American Express* expressly overruled *Wilko* and declared that predispute agreements to arbitrate claims arising under the Securities Act

58. *Id.* at 217. The Federal Courts of Appeals were divided on this issue. The 5th, 9th, and 11th circuits relied on the doctrine of “intertwining”, whereby arbitrable and non-arbitrable claims that are “sufficiently intertwined factually and legally” may be tried together in a federal court, even when faced with a motion to compel the arbitration of the arbitrable claim. The 6th, 7th, and 8th circuits have held that the District Courts do not have the discretion to deny a motion to compel arbitration where both arbitrable and non-arbitrable claims are involved. *Id.* at 216-17.

59. *Mitsubishi*, 473 U.S. at 614.

60. A car manufacturer (Mitsubishi) brought suit against a car dealer (Soler) for a variety of claims arising out of an alleged breach of a sales agreement between the parties. The agreement contained a clause that provided for arbitration of any disputes before the Japan Commercial Arbitration Association. Soler counterclaimed asserting, inter alia, antitrust violations. The District Court ordered arbitration of the antitrust claims, relying on the Supreme Court decision in *Scherk*. The Court of Appeals reversed insofar as the District Court’s order to arbitrate the antitrust claims.

61. *Id.* at 628.

62. *Id.*

63. *Id.* at 626, citing *Moses Cone*, 460 U.S. at 24-25.

64. *McMahon*, 482 U.S. at 238.

were enforceable.⁶⁵ Thus the court has finally declared that *Wilko* was incorrectly decided⁶⁶ and has fully recognized that the system of arbitration is adequate to ensure the purpose and intent of the Securities Act and Exchange Act as set forth by the Congress.⁶⁷

III. THE PREDISPUTE AGREEMENT TO ARBITRATE: CLAIMS THAT ARE COVERED AND THE EXTENT OF ENFORCEMENT

A. TYPICAL ARBITRATION CLAUSES

A customer desiring to transact business with a securities broker⁶⁸ today has a number of choices when making their selection. There are full service brokers and discount brokers, both of whom provide a variety of services. The full service brokerage house usually assigns an individual to the customer who becomes the investor's personal account executive. Upon the formation of this relationship, customers are typically asked to sign a customer agreement form which will contain information about the investor such as their financial status, investment goals, and experience in investing and dealing in the securities market. Additionally, the nature and extent of the relationship with the broker that the investor can expect⁶⁹ is usually explained.

Along with the rules and regulations governing the relationship, the customer agreement forms will often contain an arbi-

65. *Rodriguez*, 109 S. Ct. at 1922.

66. In concluding that *Wilko* was incorrectly decided, the Supreme Court stated the purpose of such a ruling: "Although we are normally and properly reluctant to overturn our decisions construing statutes, we have done so to achieve a uniform interpretation of similar statutory language, [citations omitted] and to correct a seriously erroneous interpretation of statutory language that would undermine congressional policy as expressed in other legislation [citations omitted]. Both purposes would be served here by overruling the *Wilko* decision." *Id.* at 1922.

67. See *McMahon*, 482 U.S. at 233; see also *supra* note 16.

68. In this article, a securities broker will also be referred to as a "broker" or "stock broker". For the purposes and scope of this article, the brokers referred to are primarily those that handle retail customer accounts.

69. Customer agreements vary as to their content depending on the broker and the type of account that is involved. Typically, brokers will have different types of agreements depending on whether it is a cash, margin, or option account. This is especially true with respect to whether or not there is an arbitration clause contained within it. See *infra* note 120.

tration clause. The typical arbitration clause contains language to the effect that “any controversy arising out of the broker/client relationship be settled by arbitration.”⁷⁰ The clause may specify the arbitral forum and the rules which will govern the process, often letting the customer choose from the forums listed in the agreement.⁷¹

The arbitration clause contained in a customer agreement is now more than just “boilerplate” language.⁷² The language of the clause must be highlighted by distinguishable type, in outline form, and noticeable to the customer.⁷³ Additionally, the language of the clause must inform the customer that they, by signing the agreement, will be waiving their rights to court remedies.⁷⁴

Recently, the Court of Appeals of New York ruled that absent an express writing limiting the arbitrable forum, a customer may elect to arbitrate their claim before the American Arbitration Association (AAA) instead of one of the securities industry sponsored forums.⁷⁵ This ability of a customer to elect to arbitrate their claim before the AAA came about as a result of how the customer agreement was worded with respect to arbitrating future disputes.⁷⁶

70. Typical arbitration clauses in retail customer agreements may also include which disputes may be arbitrated and may also contain where and under whose rules arbitration will occur.

71. Forums available for arbitration include the systems available under the Self Regulatory Organizations (SRO's), the American Arbitration Association, and perhaps private judging.

72. See generally *Adams v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 888 F.2d 696 (10th Cir. 1989) (customer claims of a customer agreement as being a form, boilerplate contract).

73. See S.E.C. order, *infra* note 101 at 21153.

74. *Id.*

75. *Cowen & Co. v. Anderson*, 76 N.Y.2d 318 (1990). See also *infra* note 101 and accompanying text.

76. The customer agreement in *Cowen* provided for arbitration in “accordance with the rules then in effect” at a number of the SRO's. Under the rules of the AMEX's constitution (often referred to as the AMEX Window), AAA arbitration was permitted. For a discussion of the “AMEX Window” and its ramifications see Franklin, *Amex Window Debate; Cowen Renews Struggle over Arbitration Forums*, N.Y.L.J., July 19, 1990 at 5.

B. ARBITRABLE CLAIMS

As indicated in the previous section, typical arbitration clauses usually do not specify exactly which type of controversies between the customer and the broker that will be arbitrable. "Any controversy" is a broad area.⁷⁷ The anti-fraud provisions contained in section 12(2) of the Securities Act of 1933 and section 10(b) of the Securities Exchange Act are by far the most common claims brought by customers against brokers.⁷⁸ The Supreme Court has indicated that the arbitration system as it exists today is fully capable of addressing those claims where there has been an agreement to do so.⁷⁹ Any question about the enforceability of arbitration agreements where sections 12(2) and 10(b) are claimed, have been answered affirmatively.⁸⁰

Securities Act and Securities Exchange Act claims are not the only claims that have been brought against brokers where questions of arbitration have arose. The Racketeer Influenced and Corrupt Organizations Act⁸¹ (RICO) is another claim which clients have leveled against their brokers. RICO's main advantage to the customer when asserting a claim against their broker is the treble damage provision contained in section 1964(c).⁸²

Prior to *Shearson/American Express v. McMahon*,⁸³ civil RICO claims concerning securities disputes were generally not held subject to arbitration.⁸⁴ The court in *McMahon*, in address-

77. Brokerage firms in-house resolution procedures vary, but all have internal methods of dealing with disputes that may arise between brokers and their clients.

78. See e.g., *Rodriguez De Quijas v. Shearson/American Express Inc.*, 109 S. Ct. 1917 (1989); *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220 (1987).

79. See *McMahon*, 482 U.S. at 233 (the expansive power of the S.E.C. to ensure the adequacy of the arbitration procedures of the SRO's); see also *supra* notes 66-67 and accompanying text and *supra* note 16.

80. *Rodriguez*, 109 S. Ct. at 1922 (1989); *McMahon*, 482 U.S. at 238 (1987).

81. 18 U.S.C. § 1964(c) (1988).

82. *Id.*; see also *McMahon* at 241, quoting Representative Steiger about the remedial purpose of the provision: "It is the intent of this body, I am certain, to see that innocent parties who are the victims of organized crime have a right to obtain proper redress. . ." *Id.* at 240. The court also noted that "the treble-damages cause of action. . . seeks primarily to enable an injured competitor to gain compensation for that injury." The court was displaying the importance of the treble-damages provision of § 4 of the Clayton Act and analogizing its legislative intent to that of the RICO statute. *Id.* at 240.

83. *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220 (1987).

84. See e.g., *Page v. Moseley, Hallgarten, Estabrook & Weeden, Inc.* 806 F.2d 291,

ing the RICO claim brought by an investor, relied heavily on their decision in *Mitsubishi*.⁸⁵ By looking at the legislative text and history of the statute, the court determined that there was nothing contained in it that evidenced a Congressional intent to exclude civil RICO claims from the “dictates of the Arbitration Act.”⁸⁶ The major arguments presented to the court in *McMahon* which would preclude the submission of civil RICO claims to arbitration included the complexity of the RICO claim,⁸⁷ the overlap of criminal and civil provisions, and the public interest involved in RICO enforcement.⁸⁸ These arguments were dismissed by the court declaring that the RICO claims could effectively be vindicated in an arbitral forum.⁸⁹

C. ATTEMPTS TO CIRCUMVENT ARBITRATION

Section 2 of the Arbitration Act declares that as a matter of federal law, arbitration agreement “shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.”⁹⁰ Defenses available to the investor seeking to keep their claim out of the arbitration process will become increasingly more difficult to assert. In the past, investors have claimed that the arbitration clauses contained within customer agreements were obtained by fraud, or that the contracts themselves were adhesive.⁹¹

298 (1st Cir. 1986) (“ . . . we believe the Congressional intent [of RICO] to have been one of precluding arbitration. . . .”); *Tashea v. Bache, Halsey, Stuarts, Shields, Inc.*, 802 F.2d 1337, 1339 (11th Cir. 1986) (holding that RICO claims based on violations of the 1933 and 1934 Acts are not subject to compelled arbitration); *Jacobson v. Merrill, Lynch, Pierce, Fenner & Smith*, 797 F.2d 1197, 1202 (3d Cir. 1986) (RICO claims based on 10b-5 violations not subject to arbitration).

85. See *McMahon* 482 U.S. at 239-41.

86. *Id.* at 242.

87. *Id.* at 239. The Court responded to this argument by relying on its decision in *Mitsubishi* where it stated that “potential complexity should not suffice to ward off arbitration.” *Id.* (quoting *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth Inc.*, 473 U.S. at 633). The Court further stated that antitrust matters are “every bit as complex as RICO claims”, that the arbitral system’s “adaptability and access to expertise” could handle complex claims, *id.*, and that “arbitral tribunals are readily capable of handling the factual and legal complexities. . . .” *Id.* at 232.

88. *Id.* at 239-41.

89. *Id.* at 242. The court stated that the “McMahons may effectively vindicate their RICO claim in an arbitral forum. . . .”

90. *Id.* at 226 quoting section 2 of the F.A.A., 9 U.S.C. § 2 (1982).

91. See *Rodriguez De Quijas v. Shearson/American Express*, 109 S. Ct. at 1921 (1989) (record devoid of facts supporting agreement to arbitrate as adhesive); *Cohen v.*

Claims by investors that they were fraudulently induced to sign or misled as to the effect of signing a customer agreement that contains an arbitration clause usually fail to keep a claim from being arbitrated.⁹² It is well established that general attacks on the entire customer agreement as being fraudulently induced are subject to arbitration.⁹³ Specific attacks on the arbitration clause itself could conceivably permit court adjudication of these issues.⁹⁴ Allegations of fraud as they relate to the clause itself will not necessarily allow the dispute to enter into a judicial forum.⁹⁵ A broker that fails to inform the client as to the existence and effect of the clause has not committed actionable fraud unless there is a duty to disclose.⁹⁶ Since a broker does not have a duty to disclose or explain an arbitration clause contained within a customer agreement,⁹⁷ claims of fraud as they relate to the clause itself will also fail.

Asserting that the arbitration clause is a part of a contract

Wedbush, Noble, Cooke, Inc., 841 F.2d 282 (9th Cir. 1988) (claim of fraud for failure to disclose effect of arbitration clause).

92. See *Bitkowski v. Merrill, Lynch, Pierce, Fenner & Smith*, 866 F.2d 821 (6th Cir. 1988) (broker did not conceal nor discuss the contents of the customer agreement); *Russo v. Simmons*, 723 F. Supp. 220, 224 (S.D.N.Y. 1989) (customer claim of fraudulent inducement to be decided by arbitrator).

93. *Curtis v. Newhard, Cook & Co., Inc.*, 725 F.Supp 1072, 1074 (E.D. Mo. 1989). See e.g., *Cohen v. Wedbush, Noble, Cooke, Inc.*, 841 F.2d 282, 286 (9th Cir. 1988); *Villa Garcia v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 833 F.2d 545, 548 (5th Cir. 1987); *Bhatia v. Johnston*, 818 F.2d 418, 421-22 (5th Cir. 1987); *Benoay v. Prudential-Bache Sec. Inc.*, 805 F.2d 1437, 1441 (11th Cir. 1986).

94. *Prima Paint Co. v. Flood & Conklin Mfg.*, 388 U.S. 395, 403-4 (1967). The Court explained that if the claim is fraud in the inducement of the arbitration clause itself, an issue which goes to the "making" of the agreement to arbitrate, the federal court may proceed to adjudicate it. *Id.*

95. See *Cohen*, 841 F.2d at 286-87. The customer contended that Wedbush's failure to inform them of the ramifications of the arbitration clause was not aimed at the entire contract but only on their assent to the arbitration clause. The court stated that: "This does not mean, however, that the Cohens are entitled to a jury trial. In order for a mere omission to constitute actionable fraud, a plaintiff must first demonstrate that the defendant had a duty to disclose the fact at issue." *Id.* at 286-87.

96. *Chiarella v. United States*, 445 U.S. 222, 228 (1980) (failure to disclose is fraud only when there is a duty to do so); *Cohen*, 841 F.2d at 287 (no duty to disclose or explain terms of a written contract).

97. *Rush v. Oppenheimer & Co.*, 681 F.Supp 1045, 1052 (S.D.N.Y. 1988) (brokers are not required as a matter of law to disclose or explain arbitration clauses); see also *Adams v. Merrill Lynch, Pierce, Fenner & Smith*, 888 F.2d 696, 701 (10th Cir. 1989) (When an investor signs an agreement, the law presumes that one has read that which one has signed); *Pierson v. Dean Witter Reynolds, Inc.*, 742 F.2d 334, 339 (7th Cir. 1984) (failure by an investor to inquire about the effects of the arbitration clause can't be used to avoid arbitration).

of adhesion is also rarely successful in keeping claims out of arbitration.⁹⁸

IV. ADVANTAGES OF ARBITRATION IN BROKER-CLIENT DISPUTES: THE ADEQUACY OF THE SYSTEM

A. ADVANTAGES OF ARBITRATION

This section of the note will explore the positive effects and advantages of the Supreme Court's decision in *Rodriguez* when a dispute that arises between securities brokers and their clients is arbitrated. Customers, effectively shut out of the courts after signing an agreement that contains an arbitration clause, are nonetheless still adequately protected as was intended by Congress when the Securities Act and the Securities Exchange Act were passed.⁹⁹ The mistrust of the arbitration system as displayed by the court in *Wilko* has deteriorated to the point of near non-existence¹⁰⁰ and the regulatory changes¹⁰¹ that have taken place since *Wilko* have cast doubt aside as to the effectiveness of arbitration.

98. See e.g., *Rodriguez De Quijas*, 109 S. Ct at 1921; *Adams*, 888 F.2d at 700; *Cohen*, 841 F.2d at 286; *Surman v. Merrill, Lynch, Pierce, Fenner & Smith*, 733 F.2d 59, 61 (8th Cir. 1984) (rejection of argument that brokerage agreements were contracts of adhesion); *Schuster v. Kidder, Peabody & Co.*, 699 F. Supp. 271 (S.D. Fla. 1988) (rejection of argument that customer agreements were contracts of adhesion that were lacking mutuality of obligation).

99. See *supra* notes 42-46 and accompanying text.

100. See *Rodriguez* at 1920.

101. See, *Self Regulatory Organizations; Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc., National Association of Securities Dealers, Inc., and the American Stock Exchange Inc. Relating to the Arbitration Process and the Use of Pre-dispute Arbitration Clauses*, 54 Fed. Reg. 21144 (1989). This order approved a number of changes filed by the SRO's with the S.E.C. in response to an S.E.C. letter to the SICA which indicated a number of areas that arbitration reform might be necessary. The areas of approved changes included:

1. Service of Pleadings
2. Classification of Arbitrators
3. Arbitrator Disclosure and Background Information to be disclosed to the Parties
4. Appointment of Replacement Arbitrators on Panel
5. Availability of Small Claims Procedures and the Number of Arbitrators Required to Hear a Claim
6. Discovery
7. Preservation of Record
8. Content and Availability of Award
9. Arbitration Fees
10. Pre-dispute Arbitration Clauses

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These rule changes were the result of actions by the S.E.C.¹⁰² which saw the need for changes in the current system of arbitration and the rules regulating it. The Securities Industry Conference on Arbitration (SICA)¹⁰³ and the Self Regulatory Organizations (SRO's)¹⁰⁴ have worked to ensure that the arbitration system is both fair and efficient. The obvious advantage that will be enjoyed by the customer are the time and cost savings that will be realized by the submission of disputes to arbitration.¹⁰⁵ Undoubtedly, these advantages will extend to the broker as well.

The greatest savings on costs will result from the reduced time spent in settling a claim through arbitration as opposed to litigation.¹⁰⁶ This reduction in time is the direct result of expedited filing, discovery, and hearing procedures.¹⁰⁷ This equates into lesser legal costs as a percentage of arbitral awards.¹⁰⁸

The fairness of the process of arbitration is another important advantage to the securities customer. The composition of the arbitral panels are composed of a majority of individuals who are not affiliated with the securities industry and a minority

102. See *id.*, referring to the letter from Richard G. Ketchum, Director, Division of Market Regulation, S.E.C. to James E. Buck, Senior Vice-President, New York Stock Exchange Inc., dated September 10, 1987.

103. The Securities Industry Conference on Arbitration is comprised of a representative from each of the self-regulatory organizations which administers an arbitration program, a representative from the securities industry, and four public representatives.

104. The SRO's which have an arbitration program are the New York Stock Exchange, Pacific Stock Exchange, National Association of Securities Dealers, American Stock Exchange, Chicago Board of Exchange, Municipal Securities Rulemaking Board, Boston Stock Exchange, Cincinnati Stock Exchange, and Philadelphia Stock Exchange.

105. See Note, *Classwide Arbitration and 10b-5 Claims in the Wake of Shearson/American Express Inc. v. McMahon*, 74 CORNELL L. REV. 380, 391 (1989); See also Fletcher, *Learning to Live With the Federal Arbitration Act—Securities Litigation in a Post-McMahon World*, 37 EMORY L.J. 99, 122 (1988).

106. See Note, *Arbitration of Securities Disputes: Rodriguez and New Arbitration Rules Leave Investors Holding a Mixed Bag*, 65 IND. L.J. 697, 707 (1990) (599 days for litigated claims and 434 days for arbitrated claims). But see Hayes & Hagedorn, *Arbitration Saves Money, But Not Time*, Wall St. J., Sept. 5, 1990, at B7, col. 1 (referring to a study by the Rand Corporation's Institute for Civil Justice showing that arbitrated cases took an average of 285 days and nonarbitrated cases 282 days).

107. See S.E.C. order, *supra* note 101 at 21145.

108. See Note *supra* note 106, appendix (letter from Deloitte Haskins & Sells to the New York Stock Exchange (undated) showing that in a survey that it conducted, the legal costs as a percentage of awards was 28.75% for arbitrated claims and 79.66% for litigated claims).

of those who are in some way connected with the industry.¹⁰⁹ Arbitrators are now subject to closer scrutiny as to their industry affiliations, both present and past, which goes far in assuring that the investor will be adequately protected.¹¹⁰ The past practice of not keeping a record of the arbitration proceedings no longer exists.¹¹¹ Arbitrators are now required to keep a record of the proceedings and allow access to these records by each of the parties.¹¹² Having a record of the proceedings will enable the parties to more readily appeal an arbitral award by allowing a court a means of reviewing the proceedings.¹¹³

Perhaps the greatest advantage to the customer in the recent rule changes will result from the customer's heightened awareness of knowing what arbitration is and how it will affect them in the event that a dispute does arise in the broker-client relationship. The highlighting of the arbitration clause and the brief explanation of what it means¹¹⁴ will put prudent investors on notice so that they may arm themselves with the knowledge necessary to make an informed decision.

B. INVESTOR CHOICE

The Court of Appeals of New York decision in *Cowen v. Anderson*¹¹⁵ seems to suggest that a choice of forum, other than those sponsored by the securities industry, will be available to

109. See S.E.C. order, *supra* note 101; see also Note, *supra* note 106, at 710.

110. See *id.*, see also National Association of Securities Dealers, Inc., Code of Arbitration Procedure § 19 (1988).

111. S.E.C. order, *supra* note at 21151.

112. *Id.*

113. The standards used by a court in vacating an award are found in 9 U.S.C. § 10 (1982). They include in part:

- 1) Where the award was procured through corruption, fraud, or undue means.
- 2) Where there was evident partiality or corruption in the arbitrators.
- 3) Arbitrator misconduct.

114. S.E.C. order, *supra* note 101 at 21153.

115. *Cowen & Co. v. Anderson*, 76 N.Y.2d 318 (1990). In *Cowen*, the customer, Anderson, sought to arbitrate a claim before the American Arbitration Association (AAA) in accordance with the account agreements he had signed which contained clauses providing that disputes be settled through arbitration in accordance with the rules of the NYSE, AMEX, or NASD. Cowen sought a stay of arbitration before the AAA contending arbitration must take place in one of the three listed SRO's. The lower court denied the stay and the Court of Appeals affirmed. It stated that under the rules of the AMEX, the AAA is a forum in which an investor may seek arbitration unless there has been an express agreement to limit the forum.

investors. The American Arbitration Association¹¹⁶ (AAA) is one such forum. It can provide for the resolution of disputes between brokers and their customers in a setting away from the securities industry.

The AAA has its own set of rules tailored especially for securities disputes. In 1987, the AAA issued Securities Arbitration Rules¹¹⁷ (SAR) which, while similar to Commercial Arbitration Rules, specifically address the special needs of securities disputes.¹¹⁸ Since the SAR's were first published, there has been "a positive user response [indicating] that AAA securities arbitration is perceived to offer a fair and impartial means of resolving customer-broker disputes."¹¹⁹

Of course, the ultimate investor choice is whether or not to enter into an agreement containing an arbitration clause. There is nothing which mandates an arbitration clause in a customer agreement with a broker other than each firm's decision to use them.¹²⁰ There will always be brokers whose customer agreements do not contain arbitration clauses if there is a market for such agreements.¹²¹ However, as investors become more aware of the advantages of arbitration as a means of settling disputes and the perceived unfairness and bias of arbitration disappears,¹²² the predispute agreement to arbitrate claims will become more commonplace.

116. Friedman, *Arbitration 1989, Securities: The Latest Developments*, 115 (1989). The American Arbitration Association is a nationwide organization with a panel of over 50,000 qualified arbitrators. Approximately 1400 of these arbitrators are qualified to hear securities disputes by either industry affiliation or by knowledge with no industry affiliation. *Id.* at 117.

117. American Arbitration Association, *Securities Arbitration Rules* (amended 1989).

118. See Friedman, *AAA's New Securities Arbitration Rules*, N.Y.L.J., Sept. 8, 1987, at 1, col. 1.

119. See Friedman, *supra* note 116 at 119.

120. A study by the S.E.C. indicated that only 39% of the brokerage firms had customer agreements that contained predispute arbitration clauses for cash accounts. However, the study also showed that customer agreements for margin and options accounts did contain arbitration clauses. See S.E.C. Order, *supra* note 101 at 21153.

121. See S.E.C. Order *supra* note 101 at 21153. In the order, the S.E.C. stated that it was "hopeful that competitive forces will result in some firms offering margin or options accounts without such [arbitration] agreements." *But see* Note, *supra* note 106 at 718.

122. See L.A. Times, Dec. 13, 1987, part 4, at 1, col. 4. "Many investors . . . perceive these arbitration systems as unfairly stacked in favor of brokers, in part because panels are selected and administered by the securities industry."

V. CONCLUSION

Since the Supreme Court's ruling in *Wilko v. Swan*, there has been a continuous erosion of its holding, resulting in its eventual demise. Subsequent decisions have highlighted the erroneous holding of *Wilko* and recognized the advantages that arbitration affords the investor. Recognition of these advantages is due in part to the regulatory changes within the established system of arbitration, the disappearance of "judicial hostility toward arbitration,"¹²³ and the availability of alternative forums.

The rule changes in the arbitration system will heighten investors' awareness as to the effects of signing a customer agreement with a broker that contains an arbitration clause. Additionally, investors should take it upon themselves to become more aware of the significance of having to arbitrate any dispute that may arise from their relationship with their broker. Armed with such knowledge, investors will recognize arbitration as a fair and efficient means of resolving disputes with their brokers.

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123. See *supra* notes 23-25 and accompanying text.

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