RECENT DEVELOPMENTS

*Jevne v. Superior Court**

I. INTRODUCTION

The National Association of Securities Dealers (NASD) and other securities self-regulatory organizations (SROs) will no longer require California-based participants in arbitration proceedings to waive conflicting California standards or to agree to arbitrate disputes outside of California.[1] In *Jevne v. Superior Court*, the California Supreme Court held that the California Ethics Standards for Neutral Arbitrators in Contractual Arbitration (California Standards) were preempted by the rules for neutral arbitrators promulgated by the NASD.[2] Specifically, the court held that the California Standards' provisions on disclosure and disqualification conflicted with the corresponding NASD arbitration rules, and were thus preempted by federal securities laws.[3]

The NASD adopted its first set of arbitration rules in 1968 with the hope of aiding a growing number of small investors who found themselves involved in disputes with their brokers.[4] Currently, the NASD operates the largest dispute resolution forum in the securities industry.[5] While investors were the primary beneficiaries under the original rules,[6] subsequent developments have also benefited securities dealers by allowing them to

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* Jevne v. Superior Ct., 111 P.3d 954 (Cal. 2005).

[1] *See* Jevne v. Superior Ct., 111 P.3d 954 (Cal. 2005); Order Granting Accelerated Approval of Proposed Rule Change of the NASD Code of Arbitration Procedure Relating to the Waiver of the California Ethics Standards for Neutral Arbitrators in Contractual Arbitration, 70 Fed. Reg. 35,482 (June 30, 2005) [hereinafter California Ethics Standards for Neutral Arbitrators].

[2] *Jevne*, 111 P.3d at 963.

[3] *Id.* at 969.

[4] *See* Deborah Masucci, *Securities Arbitration—A Success Story: What Does the Future Hold?*, 31 WAKE FOREST L. REV. 183, 185 (1996).

[5] *See* NASD Dispute Resolution, http://www.nasd.com/ArbitrationMediation/index.htm (last visited August 1, 2006). The self-described purpose of NASD Dispute Resolution is to "assist in the resolution of monetary and business disputes between and among investors, securities firms, and individual registered representatives." *Id.*

[6] *See* Masucci, *supra* note 4, at 185. Initially arbitration was voluntary for both sides, but subsequent changes allowed individual investors to compel members and associated persons to arbitrate disputes. *Id.* (citing NASD Code of Arbitration Procedure § 12 (1995)).

utilize pre-dispute arbitration agreements as a means to contain litigation costs and reduce exposure.[7] This trend continued in 1987, when the U.S. Supreme Court validated the binding effect of the pre-dispute arbitration agreements commonly placed in customer account agreements by securities dealers.[8]

Although the NASD and other SROs consider arbitration to be a quick and cost-efficient alternative to litigation in which qualified neutral arbitrators serve to protect the rights of investors,[9] concerns over the adequacy of the process continue to exist among investors and lawmakers.[10] These individuals are concerned that the procedures and extensive involvement of industry insiders tend to provide an unfair advantage to brokerage firms and other repeat players.[11]

These concerns are not limited to securities dispute arbitration, but are increasingly present in all contractual arbitrations. In response to these concerns, the California Legislature enacted Code of Civil Procedure § 1281.85(a) in 2001.[12] The statute directed the California Judicial Council to establish ethical standards for neutral arbitrators serving under the direction of contractual arbitration agreements.[13] The Judicial Council responded by adopting the California Standards, which were subsequently enacted on July 1, 2002.[14]

The Judicial Council chose not to exempt SRO-administered securities arbitrations from the newly enacted standards,[15] and the SROs immediately challenged the Judicial Council's position. The basis for the challenge was their contention that the California Standards contained provisions that conflicted with the NASD Code and were therefore preempted.[16] The

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[7] *See* Norman S. Poser, *Making Securities Arbitration Work*, 50 SMU L. REV. 277, 280–87 (1996).

[8] *See* American Express, Inc. v. McMahon, 482 U.S. 220 (1987).

[9] *See* Securities Industry Association, *Arbitration Is Fair, Fast and Economical for Investors*, Jan. 29, 2004, http://www.sia.com/press/pdf/ArbitrationTalkingPoints2003.pdf.

[10] *See* Jill I. Gross, *Securities Mediation: Dispute Resolution for the Individual Investor*, 21 OHIO ST. J. ON DISP. RESOL. 329, 338 (2006).

[11] *Id.*

[12] *See* Cal. Assem. Com. On Judiciary, Analysis of Sen. Bill No. 475 (2001–2002 Reg. Sess.).

[13] *See* Jevne v. Superior Ct., 111 P.3d 954, 962–63 (Cal. 2005).

[14] *Id.* at 957.

[15] *Id.* at 960 n.4.

[16] Brief for Securities and Exchange Commission as Amicus Curiae Supporting Petitioners, Jevne v. Superior Ct., 111 P.3d 954 (Cal. 2005) (No. B167044), 2003 WL 23140037.

outcome of these challenges held enormous importance not only for the SROs, but also for securities dealers and individual investors. As such, the court's holding in *Jevne* represents the most recent chapter in the development of arbitration in the securities industry.

II. FACTUAL AND PROCEDURAL HISTORY

In 1996, Jack Jevne opened an account in the name of Avalon Investments, S.A. (Avalon) with JB Oxford & Company (Oxford), a licensed securities broker dealer and member of the NASD.[17] In order to open the account, Jevne was required to sign an "account opening statement," which directed that all disputes with Oxford would be resolved through arbitration in accordance with the NASD Code.[18] A dispute arose over Oxford's handling of the account, and suit was filed on behalf of Jevne and Avalon in August of 2000.[19]

Pursuant to the provisions of the account opening statement, the parties initially agreed to resolve their dispute through arbitration.[20] In September of 2002, an individual on the arbitration panel disqualified himself for undisclosed reasons, and the panel put the proceedings on hold pending the replacement of the disqualified member.[21]

The California Judicial Council's recent enactment of the California Standards on July 1, 2002 further complicated matters. As a result of perceived conflicts between the provisions of the NASD Code and the California Standards, the NASD stopped appointing arbitrators for California disputes unless the parties agreed to sign a waiver of the California Standards or agreed to continue the arbitration in another state.[22]

Jevne refused to sign the waiver, and instead, he sought to restore the matter to the active civil trial calendar.[23] The trial court denied Jevne's motion and the court of appeals affirmed the decision.[24] The court of appeals denied a rehearing on the matter, and the California Supreme Court granted

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[17] *Jevne*, 111 P.3d at 958.

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] *Id.* at 959.

[22] *Id.*

[23] *Jevne*, 111 P.3d at 959.

[24] *Id.* at 960.

review to determine whether the corresponding provisions of the NASD Code preempted the California Standards.[25]

III. THE COURT'S HOLDING AND REASONING

The California Supreme Court held that NASD rules, which the Securities Exchange Commission (SEC) approved pursuant to 15 U.S.C. § 78s(b)(2), preempted state law when the two were in conflict.[26] After acknowledging that the Securities Exchange Act of 1934 (SEA) contained no provision for express preemption and that the field of securities arbitration was not one that Congress intended the federal government to occupy exclusively, the court focused its analysis of preemption on the alleged conflict between the NASD Code and the California Standards.[27]

To find preemption based on conflict between federal and state law, the court first had to establish that the NASD Code held the force of federal law.[28] The court then had to establish the existence of a conflict between the NASD Code and the California Standards.[29]

A. *Preemptive Force of the NASD Code*

In order to find preemption through conflict, the court needed to establish that the NASD Code carried the force of federal law. The court's conclusion that the NASD Code carried the force of federal law was derived, in large part, from Congress's 1975 Amendment to § 19 of the SEA, which substantially altered the balance of rulemaking power in favor of oversight by the SEC.[30] More precisely, the amendment removed the SROs' authority for independent regulation, and granted 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 procedures adequately protect statutory rights."[31]

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[25] *Id.* at 958.

[26] *Id.* at 960.

[27] *See id.* at 964.

[28] *Id.*

[29] *See Jevne*, 111 P.3d at 964.

[30] *Id.* at 966.

[31] *Id.* (quoting American Express, Inc. v. McMahon, 482 U.S. 220, 233–234 (1987)).

The court determined that the SEC's approval of an NASD rule was an "expression of federal policy that *may* have preemptive effect" so long as the requisite conflict exists.[32]

B. *Conflict Between the NASD Code and the California Standards*

After determining that the NASD Code could, under the right circumstances, carry the force of federal law, the court's analysis turned to the question of whether a genuine conflict existed between the California Standards and the NASD Code. The court explained that conflict preemption applies in two situations: (1) when it is impossible to comply with both the federal and the state law, and (2) when enforcement of state law could prevent or impair the accomplishment of the purposes and objectives of federal law.[33]

The court restricted its review to Standards 7, 8, and 10 of the California Standards because those were the standards previously found to be in conflict by the court of appeals.[34] The court held that Standards 7 and 8, which related to heightened disclosure requirements, conflicted with the NASD Code because they impaired the accomplishment of the objectives of investor protection found in the SEA.[35] Specifically, the court found that the California disclosure standards would increase administrative costs, deter the participation of qualified arbitrators, and ultimately, increase the complexity, cost, and uncertainty of the arbitration process.[36]

The court also found a conflict with regard to Standard 10, which related to arbitrator disqualification, because the standard was "fundamentally irreconcilable" with the corresponding NASD Code provisions.[37] Specifically, the court noted that if an arbitrator failed to make a required disclosure and a party served notice of disqualification, the California Standards required disqualification, while the NASD Code granted discretion to the NASD Director of Arbitration to decide whether the disqualification should occur.[38]

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[32] *Id.* at 966 (emphasis in original).

[33] *Id.* at 964.

[34] *Id.* at 966.

[35] *Jevne*, 111 P.3d at 969–70.

[36] *See id.* at 968–69.

[37] *Id.* at 970.

[38] *Id.*

IV. IMPACT OF THE COURT'S RULING

The court's holding that the California Standards are preempted by the provisions of the NASD Code to the extent that they attempt to regulate SRO-administered securities arbitrations has far-reaching implications for the future of SRO directed arbitrations, the California Standards, and the use of alternative dispute resolution within the field of securities-related disputes.

A. *The Future of SRO Arbitration*

The ruling of the *Jevne* Court was a decisive victory for the NASD and other SROs to the extent that the decision acknowledged the status of SROs in general, and of the NASD in particular, as the preeminent forums for the arbitration of securities-related disputes.[39] The ruling sent a clear message that state laws which conflict with or curtail the authority of SROs in the field of securities-related dispute arbitrations will not survive a legal challenge.[40]

Following the *Jevne* decision in the California Supreme Court and a similar holding in the Ninth Circuit Court of Appeals,[41] the NASD and other SROs quickly altered their rules to effectuate the courts' holdings.[42] Prior to *Jevne*, the NASD required California participants to either waive the California Standards or to agree to arbitrate the dispute outside of the state.[43] Following the *Jevne* decision, the NASD declared its authority and removed the waiver requirements.[44]

In addition to acknowledging the superiority of SRO arbitration rules, the ruling also put the NASD in a position to better effectuate the goals of the SEA. By removing the burden of heightened disclosure requirements, the

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[39] *See Continuing California ADR Developments*, 59 DISP. RESOL. J. 6, 6 (2004).

[40] *See, e.g.*, Schachle v. Merrill Lynch, Pierce, Fenner & Smith, No. G032194, 2005 WL 1822517 (Cal. Dist. Ct. App. Aug. 3, 2005); Gorman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. H027488, 2005 WL 1576869 (Cal. Dist. Ct. App. July 5, 2005).

[41] *See* Credit Suisse First Boston Corp., 400 F.3d 1119 (N.D. Cal. 2005).

[42] *See* California Ethics Standards for Neutral Arbitrators, 70 Fed. Reg. 35,482 (June 20, 2005); Order Approving Proposed Rule Change to Order Audit Trial Systems Rules, 70 Fed. Reg. 57,909, 57,916 (Oct. 4, 2005); Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change to Rule 600, Relating to Arbitration, 70 Fed. Reg. 76,094 (Dec. 22, 2005).

[43] NASD Code of Arbitration Procedure, rule IM-10100(f), *repealed by* California Ethics Standards for Neutral Arbitrators, 70 Fed. Reg. 35,482.

[44] *See* California Ethics Standards for Neutral Arbitrators, 70 Fed. Reg. 35,482.

Jevne decision ensured that the most qualified arbitrators would not be dissuaded from participating in the process.[45] The decision also made it easier for the SEC to establish consistent nationwide procedures for the arbitration of securities disputes.[46]

B. *The Future of the California Standards*

While the court's ruling was clearly a defeat for the California Standards,[47] the ruling only struck down the California Standards' ability to influence SRO-administered arbitrations. As to all other commercial arbitrations in California, the Standards remain in full force.[48]

Just as the *Jevne* decision generated quick authorization for SRO rule changes at the SEC, the California Judicial Council was also quick to act on the court's ruling.[49] Following *Jevne*, the Judicial Council proposed an amendment that would exempt securities dispute arbitrations from the coverage of the California Standards.[50] The Judicial Council also seized upon this opportunity to begin a larger dialogue concerning the overall validity and functionality of the California Standards.[51] Motivated by the outcome in *Jevne*, the California dispute resolution community appears eager to participate in this dialogue.[52]

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[45] *See Follow Up: Comment Period Is Reopened for California Arbitrator Ethics Standards*, 24 ALTERNATIVES TO HIGH COST LITIG. 8, 9 (2006). John Blackman, current president of the California Dispute Resolution Council, has described the problems with the California Standards, "There are so many traps or ambiguities that crop up when you do or say things. . . . We're losing quality arbitrators." *Id.*

[46] *See* Brief for Securities and Exchange Commission as Amicus Curiae Supporting Petitioners, *supra* note 16, at *11.

[47] *See supra* note 39.

[48] *See* Jevne v. Superior Ct., 111 P.3d 954, 972 (Cal. 2005).

[49] *See* Request for Comments on Current Ethics Standards for Neutral Arbitrators, http://www.courtinfo.ca.gov/invitationstocomment/documents/sp05-10.pdf (last visited Sept. 27, 2006).

[50] *Id.* The proposed amendment would state: "These standards do not apply to any arbitrator serving in an arbitration proceeding governed by rules adopted by a securities self-regulatory organization and approved by the United States Securities and Exchange Commission under federal law." *Id.*

[51] *See id.* (requesting comments and suggestions on how to improve all of the California Standards).

[52] *See supra* note 45.

C. *The Future of ADR in Securities-Related Disputes*

Participants in the arbitration process will not see many changes as a result of the outcome in *Jevne* because the holding, in effect, directed that the existing SRO arbitration procedures should remain in place. As such, the same benefits and detriments perceived by parties prior to *Jevne* still exist after the ruling. Many will continue to view arbitration as a speedy, inexpensive, and fair alternative to litigation,[53] while others will continue to view SRO-directed arbitration as an option which increasingly resembles traditional litigation and also tends to benefit securities dealers at the expense of individual investors.[54]

The ruling in *Jevne* effectively forecloses any future challenges to the supremacy of SRO standards for the arbitration of securities-related disputes.[55] With this consolidation of power, it is likely that new questions will be raised concerning the limited availability of alternatives to SRO-directed arbitration.[56] This potential is clearly visible through the growing use of mediation as an alternative to arbitration in securities disputes,[57] and through the growing number of people who view mediation as the "expeditious, cost-effective alternative to arbitration."[58]

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[53] *See* Securities Industry Association, *supra* note 9.

[54] *See* Gross, *supra* note 10, at 338.

[55] *See* Schachle v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. G032194, 2005 WL 1822517 (Cal. Dist. Ct. App. Aug. 3, 2005); Gorman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. H027488, 2005 WL 1576869 (Cal. Dist. Ct. App. July 5, 2005).

[56] *See* Gross, *supra* note 10, at 339.

[57] *Id.* at 340.

[58] *Id.* at 344 (quoting DAVID ROBBINS, SECURITIES ARBITRATION PROCEDURE MANUAL § 16-1 (5th ed. 2003)).

V. CONCLUSION

In *Jevne*, the California Supreme Court acknowledged the supremacy of SEC-endorsed SRO procedures for the arbitration of securities-related disputes. The immediate effect of this holding will be a continuation of adherence to SRO guidelines, but without the confusion and apprehension associated with the potential for challenges from state laws. The long-term impact will likely include an exploration of alternative means of attacking the SROs' supremacy, as well as an exploration of alternatives to arbitration as the most common means of resolving securities-related disputes.

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