

## SECTION 10(b) AND RULE 10b-5 FEDERAL SECURITIES LAW CLAIMS: THE NEED FOR THE UNIFORM DISPOSITION OF THE ARBITRATION ISSUE

*In the securities industry, pre-dispute arbitration clauses are standard features in investment contracts. Although the United States Arbitration Act mandates the enforcement of arbitration agreements, many courts have refused to enforce investment contract arbitration clauses fearing a lack of investor protection. This Comment takes note of the Supreme Court's recent grant of review in McMahon v. Shearson/American Express, Inc. and urges that, given changes in structure, securities industry arbitration clauses should be enforced as protecting investors while providing a more efficient method of resolving securities disputes.*

### INTRODUCTION

An expanding "array of investment vehicles" has heightened "public involvement in financial markets."<sup>1</sup> The resulting increase in litigation between investors and members of the security industry has produced a corresponding increase in the use of pre-dispute arbitration clauses.<sup>2</sup> Although these clauses are standard features in investment contracts,<sup>3</sup> many courts have refused to enforce them. Instead, arbitration often is stayed pending the litigation of the investor's claim.

Arbitration is an alternative method of dispute resolution designed to circumvent the costs, delays and frustrations of traditional litigation. The United States Arbitration Act of 1925 (Federal Act)<sup>4</sup> was designed to enforce private arbitration agreements, and evidences a strong federal policy favoring arbitration.

The Second Uniform Arbitration Act (Uniform Act),<sup>5</sup> passed in 1955, guarantees parties to arbitration various rights and affords ar-

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1. Katsoris, *The Arbitration of a Public Securities Dispute*, 53 *FORDHAM L. REV.* 279 (1984).

2. *Id.* at 279-80.

3. Note, *Investor-Broker Arbitration Agreements: Dean Witter Reynolds, Inc. v. Byrd*, 20 *U.S.F. L. REV.* 101, 108 (1985).

4. United States Arbitration Act, ch. 213, 43 Stat. 883 (1925), 9 U.S.C. §§ 1-14 (1982).

5. UNIF. ARBITRATION ACT, 7 U.L.A. 5 (1985).

bitrators various powers. Additionally, the Uniform Code of Arbitration (Uniform Code),<sup>6</sup> developed by the securities industry, is designed to promote impartiality of arbitral forums. Despite such advances, the applicability of arbitration to securities disputes is fraught with uncertainty. This uncertainty arises from *Wilko v. Swan*,<sup>7</sup> a 1953 United States Supreme Court decision.

Congress enacted the Securities Act of 1933 (1933 Act)<sup>8</sup> and the Securities Exchange Act of 1934 (1934 Act)<sup>9</sup> to protect investors against fraudulent practices and price manipulation. To further this goal, the Supreme Court in *Wilko* refused to allow arbitration of section 12(2) claims arising under the 1933 Act, and thereby created an exception to the Federal Act. Subsequently, the issue arose whether the *Wilko* doctrine of exclusive federal court jurisdiction in securities actions applied to section 10(b) claims under the 1934 Act. The Supreme Court, while declining to resolve the issue, twice has questioned the applicability of *Wilko* to section 10(b) actions. In *Scherk v. Alberto-Culver Corp.*,<sup>10</sup> the Court outlined patent differences between several provisions of the 1933 and 1934 Acts. The 1933 Act provides an express private right of action, while a private action under the 1934 Act is implied. Additionally, the jurisdictional provisions of the 1934 Act are more restrictive than those of the 1933 Act. These differences later were reiterated in *Dean Witter Reynolds, Inc. v. Byrd*.<sup>11</sup>

This Comment concludes that arbitration of section 10(b) actions under the 1934 Act is appropriate. Moreover, in order to promote both the securities law policy of protecting investors and the federal policy of enforcing private arbitration agreements as evidenced by the Federal Act, certain general arbitration procedures must be modified for use in securities arbitration. Because securities laws vehemently protect investors, arbitration must assure investors a comparable and adequate level of protection. This Comment argues that, to protect investors, arbitration clauses must provide for greater discovery. Additionally, opinions by arbitrators and records of arbitration proceedings are needed to assure arbitrator compliance with the law. With such changes, arbitration can adequately protect investors and can avoid the numerous problems associated with the litigation process.

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6. UNIF. CODE ARB., reprinted in Fourth Report of the Securities Industry Conferences on Arbitration to the Securities and Exchange Commission (Nov. 1984) (Exhibit C).

7. 346 U.S. 427 (1953).

8. Securities Act of 1933, ch. 38, 48 Stat. 74, 15 U.S.C. §§ 77a-77mm (1982).

9. Securities Exchange Act of 1934, ch. 404, 48 Stat. 881, 15 U.S.C. §§ 78a-78kk (1982).

10. 417 U.S. 506 (1974).

11. 470 U.S. 213, 224-25 (1985) (White, J., concurring).

## ARBITRATION AND THE SECURITIES INDUSTRY

*Arbitration Generally*

Arbitration is the "reference of a dispute to one or more impartial persons for final and binding determination. It is private and informal, designed for quick, practical and inexpensive settlements."<sup>12</sup> Arbitration is an "orderly proceeding, governed by rules of procedure and standards of conduct prescribed by law."<sup>13</sup> The decisions are binding — differing from mediation or conciliation — and private, of interest only to the parties involved.<sup>14</sup>

Arbitration is not a new concept.<sup>15</sup> Nevertheless, arbitration agreements originally "were treated by the courts as unenforceable attempts to 'oust' the courts from lawful jurisdiction."<sup>16</sup> Only recently has enforcement of arbitration agreements and similar forum selection clauses become routine.<sup>17</sup>

Arbitration is designed to avoid the "formalities" of traditional litigation — the cost, delay and frustration associated with trial.<sup>18</sup> The parties have greater control over the hearing date, and thereby avoid the loss of valuable time while awaiting trial.<sup>19</sup> Because of the confidential nature of arbitration, greater disclosure may result.<sup>20</sup> Additionally, the parties may select their own Arbitration Judge,<sup>21</sup> often an expert in the area of the dispute, which can save the time and expense of educating a trial judge on the "technical intricacies of an

12. Comment, *The Arbitration Alternative: Its Time Has Come*, 46 MONT. L. REV. 199 (1985).

13. *Id.*

14. Kritzer & Anderson, *The Arbitration Alternative: A Comparative Analysis of Case Processing Time, Disposition Mode, and Cost in the American Arbitration Association and the Courts*, 8 JUST. SYS. J. 6, 7 (1983) (quoting R. COULSON, BUSINESS ARBITRATION — WHAT YOU NEED TO KNOW 6 (Am. Arb. Ass'n 1980)).

15. Construction agreements as early as 1871 contained arbitration clauses. See Kritzer & Anderson, *supra* note 14, at 7.

16. Sterk, *Enforceability of Agreements to Arbitrate: An Examination of the Public Policy Defense*, 2 CARDOZO L. REV. 481, 488 (1981).

17. *Id.* at 488 n.19.

18. Comment, *supra* note 12, at 200. The "real costs" of litigation may be more than financial. Parties may suffer emotional costs as well. *Id.* at 199. Additionally, traditional litigation involves public costs to maintain the judiciary. Rayner, *Arbitration: Private Dispute Resolution as an Alternative to the Court*, 22 U.W. ONT. L. REV. 33, 34 (1984).

19. Rayner, *supra* note 18, at 40. The hearing date usually is fixed upon consent of the parties. Excessive informality, however, can impede fair resolution of the dispute. *Id.*

20. This privacy, however, may not be in the public's best interest. *Id.* at 42.

21. Sterk, *supra* note 16, at 486.

industry.”<sup>22</sup>

Arbitration is more time and cost efficient than litigation. Many litigated cases can take a week or longer to try, while an arbitration hearing can be completed in two days.<sup>23</sup> Although the costs of arbitration vary with the amount claimed, the hearing location, representation of counsel, and additional factors,<sup>24</sup> a full arbitration hearing generally costs less than a full adjudication in court.<sup>25</sup> Arbitration, therefore, simultaneously encourages efficient and speedy dispute resolution, while relieving overcrowded court dockets.<sup>26</sup>

The Uniform Code<sup>27</sup> governs most arbitration proceedings in broker-investor disputes. The Uniform Code authorizes arbitrators to subpoena witnesses and documents<sup>28</sup> under the power of contempt.<sup>29</sup> Additionally, arbitrators have discretion to hear and admit evidence.<sup>30</sup>

In 1925 Congress enacted the Federal Act to counter judicial hostility towards arbitration.<sup>31</sup> The Federal Act established a “new pol-

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22. Comment, *supra* note 12, at 206. Experts, however, may be biased. Rayner, *supra* note 18, at 43.

23. Comment, *supra* note 12, at 207 (“The average hearing is scheduled for a half day.”).

24. Lipton, *Arbitration in the Securities Industry: Too Much of a Good Thing?*, 1985 Mo. J. DISPUTE RESOLUTION 151, 155.

25. Kritzer & Anderson, *supra* note 14, at 18-19.

26. Note, *Arbitrability of Disputes Under the Federal Arbitration Act*, 71 IOWA L. REV. 1137, 1142 (1986). Neither state nor federal courts “are capable of handling all the burdens placed upon them.” Burger, *Isn't There a Better Way?*, 68 A.B.A.J. 274, 277 (1982) (advocating arbitration).

27. UNIF. CODE ARB., reprinted in Fourth Report of the Securities Industry on Arbitration to the Securities and Exchange Commission (Nov. 1984) (Exhibit C).

28. Section 20(a) provides:

The arbitrator and any counsel of record to the proceedings shall have the power of the subpoena process as provided by law. However, the parties shall produce witnesses and present proofs to the fullest extent possible without resort to the issuance of the subpoena process.

*Id.* § 20(a); see also Bayer & Abrahams, *The Trouble with Arbitration*, 11 LITIG. 30, 31 (1985) (experienced arbitration lawyers must utilize deposition subpoenas). However, the witness “subpoenaed must be questioned at the arbitration hearing. This limitation in the subpoena process severely undercuts the use of a subpoena as a pre-hearing disclosure device.” Willenken, *The Often Overlooked Use of Discovery in Aid of Arbitration and the Spread of the New York Rule to Federal Common Law*, 35 BUS. LAW. 173, 182 (1979).

29. Parties usually agree on a procedure for reviewing subpoenaed documents before the arbitration hearing to save time at the hearing. Katsoris, *supra* note 1, at 287 n.52.

30. See Note, *supra* note 3, at 113 n.62.

31. 9 U.S.C. §§ 1-14 (1982). “Arbitration agreements are purely matters of contract, and the effect of the [Federal Act] is simply to make the contracting party live up to his agreement. He can no longer refuse to perform his contract when it becomes disadvantageous to him.” *Kulukundis Shipping Co. v. Amtorg Trading Corp.*, 126 F.2d 978, 985 (2d Cir. 1942) (citing H.R. REP. NO. 96, 68th Cong., 1st Sess. 1 (1924)). The Federal Act was designed to place arbitration agreements “upon the same footing as other contracts.” *Scherk v. Alberto-Culver Corp.*, 417 U.S. 506, 511 (1974) (citing H.R. REP. NO. 96, 68th Cong., 1st Sess. 1 (1924)).

icy, declaring the validity, irrevocability and enforceability" of pre-dispute arbitration agreements.<sup>32</sup> Designed to enforce private arbitration agreements, the Federal Act mandates that federal courts either stay court proceedings pending arbitration<sup>33</sup> or compel arbitration when a party refuses, fails, or neglects to arbitrate under a valid written agreement.<sup>34</sup> Thus, the court may only determine whether a valid written agreement exists which governs the claim.<sup>35</sup> In mandating the enforcement of arbitration agreements, Congress expressed a national policy favoring arbitration; to promote this policy, Congress has precluded states from requiring judicial resolution of disputes.<sup>36</sup>

The first modern state statute enforcing pre-dispute arbitration agreements was enacted in 1920.<sup>37</sup> Presently, forty-five states have enacted statutes enforcing such agreements.<sup>38</sup> Most state statutes are patterned after the Uniform Act, promulgated in 1955.<sup>39</sup> Under the Uniform Act, parties may present material evidence, cross-examine witnesses, and be represented by counsel at the arbitration hearing.<sup>40</sup>

32. 9 U.S.C. § 2 (1982); Note, *Mixed Arbitrable and NonArbitrable Claims in Securities Litigation*: Dean Witter Reynolds, Inc. v. Byrd, 34 CATH. U.L. REV. 525, 530 (1985). The Act provides that a "written provision in . . . a contract evidencing a transaction thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2 (1982).

33. 9 U.S.C. § 3 (1982):

If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court . . . upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had . . . .

34. 9 U.S.C. § 4 (1982). This section requires the court to decide the arbitrability of a claim and "upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement." *Id.*

35. Note, *supra* note 32, at 530-31. To prevail on a motion to compel arbitration, a party must establish: (1) the existence of an agreement to arbitrate; (2) the existence of an arbitrable claim; and (3) that no party waived that right to arbitrate. *Bob Ladd, Inc. v. Adcock*, 633 F. Supp. 241, 242 (E.D. Ark. 1986) (citing *McMahon v. Shearson/American Express, Inc.*, 618 F. Supp. 384, 386 (S.D.N.Y. 1985)).

36. Comment, *supra* note 20, at 203 (citing *Southland Corp. v. Keating*, 465 U.S. 1 (1984)). In *Southland Corp.*, the Supreme Court held that section 2 of the Act was substantive federal law. 465 U.S. at 12.

37. Note, *supra* note 34, at 1141. New York was the first state to enact a statute.

38. *Id.* Only Alabama, Nebraska, North Dakota, Virginia and West Virginia enforce agreements to arbitrate existing disputes but not future disputes. See ALA. CODE 6-6-1 (1977); NEB. REV. STAT. 25-2103 (1979); N.D. CENT. CODE 32-29-01 (Supp. 1985); VA. CODE 9.01-577 (1984); W. VA. CODE 55-10-1 (1981).

39. UNIF. ARBITRATION ACT, 7 U.L.A. 5 (1985).

40. Comment, *supra* note 12, at 200.

An arbitrator has the same authority to subpoena witnesses and documents,<sup>41</sup> under the contempt power,<sup>42</sup> as provided for by the Uniform Code.<sup>43</sup>

The Uniform Act is similar to the Federal Act. Under both Acts, written agreements to arbitrate future disputes are irrevocable and enforceable.<sup>44</sup> Courts may choose to compel arbitration or stay state court proceedings pending arbitration.<sup>45</sup> The strong federal policy favoring arbitration is evidenced in both Acts. Nevertheless, arbitration of securities claims often has not enjoyed the same strong federal support as has arbitration generally.

### *Securities Industry Arbitration*

The stock market crash of 1929 prompted federal regulation of securities. The 1933 Act<sup>46</sup> promotes disclosure in securities offerings to protect investors from fraudulent practices.<sup>47</sup> The 1934 Act<sup>48</sup> attempts to protect investors against stock price manipulation.<sup>49</sup> Together, the Acts require complete disclosure of relevant information in registration statements filed with the Securities and Exchange Commission (SEC).<sup>50</sup> Both Acts are designed to promote a "high standard of business ethics"<sup>51</sup> in the securities industry and require flexible interpretation to achieve their remedial purposes.<sup>52</sup>

In recent years, the use of arbitration to resolve investor-broker disputes has increased dramatically.<sup>53</sup> This increase is caused by the extensive use of pre-dispute arbitration clauses in investment contracts. As a condition to opening an account, broker-dealers (brokers) frequently request or require investor-customers (investors) to agree to arbitrate any future disputes concerning the management of the account.<sup>54</sup> These pre-dispute arbitration clauses are standard features in pre-printed margin, option, and cash account agreements.<sup>55</sup>

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41. *Id.* at 200-01.

42. Bayer & Abrahams, *supra* note 28, at 31.

43. *See supra* notes 28-29 and accompanying text.

44. Note, *supra* note 26, at 1141 n.33. The first Uniform Act, adopted in 1925, applied only to agreements to arbitrate existing disputes. *Id.* at 1140.

45. *Id.* at 1141 n.33.

46. Securities Act of 1933, 15 U.S.C. §§ 77a-77mm (1982).

47. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

48. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1982).

49. *Hochfelder*, 425 U.S. at 195.

50. Note, *supra* note 32, at 531-32 n.44.

51. SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963) (citing H.R. REP. NO. 85, 73d Cong., 1st Sess. 2 (1933)).

52. *Capital Gains Research*, 375 U.S. at 195.

53. *See Lipton*, *supra* note 24, at 154. The number of disputes themselves has increased as a result of increased public involvement in the securities markets. *See supra* text accompanying notes 1-2.

54. *See, e.g.*, Note, *supra* note 3, at 102.

55. *Id.* at 103. Moreover, these clauses often may create adhesion contracts. Kat-

They generally are broad, encompassing "any controversy."<sup>56</sup> The clauses mandate that arbitration proceedings be conducted according to the rules of self-regulatory organizations (SROs)<sup>57</sup> listed in the clause and selected by the investor.<sup>58</sup> Frequently, neither the broker nor the investor discusses arbitration when entering into the investment agreement, and the clauses become buried in "pages of small print."<sup>59</sup>

The securities industry favors arbitration as a dispute resolution method<sup>60</sup> for several reasons. Brokers dislike the delay and costs of federal litigation, especially when the amount in controversy is small. Jury awards frequently are more generous than arbitration awards, and punitive damages, generally not awarded in arbitration, may be granted in litigation.<sup>61</sup>

Securities industry arbitration forums are administered by various SROs. Before 1976 most SROs had different rules for resolving investor disputes. In June 1976 the SEC recommended developing a uniform system of arbitration procedures for use by the organizations offering arbitration facilities.<sup>62</sup> Accordingly, various SROs or-

soris, *supra* note 1, at 306-09.

56. Note, *supra* note 3, at 102. A typical clause reads as follows:

Any controversy arising out of or relating to the account of the undersigned, to transactions with you for the undersigned or to this Agreement or the breach thereof, shall be settled by arbitration in accordance with the rules then in effect of the National Association of Securities Dealers, Inc. or the Board of Governors of the New York Stock Exchange or the American Stock Exchange as the undersigned may elect. If the undersigned does not make such election by registered mail addressed to you at your main office within five days after demand by you that the undersigned make such election, then you may make such election. Judgment upon any award rendered by the arbitrators may be entered in any court having jurisdiction thereof.

Note, *supra* note 32, at 552 n.187.

57. The SROs are the American, Boston, Cincinnati, Midwest, New York, Pacific and Philadelphia Stock Exchanges, the Chicago Board Options Exchange, the Municipal Securities Rulemaking Board and the National Association of Securities Dealers, Inc. The National Association of Securities Dealers, Inc., and the New York Stock Exchange handle most arbitrations. Katsoris, *supra* note 1, at 280 n.7.

58. See Exchange Act Release No. 15,984 [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,122 (July 2, 1979). A typical clause authorizes the investor to elect the arbitration forum from a list of several SROs. Failure by the investor to elect the forum within five days after broker notification requesting the election automatically authorizes the broker to make the election. *Id.* ¶ 81,977 n.4. See *supra* note 56.

59. Note, *supra* note 3, at 118.

60. Peloso, *Agreements to Arbitrate*, 13 REV. SEC. REG. 943, 950 (1980).

61. See Note, *supra* note 32, at 551.

62. *Id.* at 548. After soliciting comments from interested parties and conducting public hearings, the SEC also recommended that all brokerage firms with public investors establish in-house complaint processing systems. *Id.*

ganized the Securities Industry Conference on Arbitration (SICA),<sup>63</sup> which developed the Uniform Code.<sup>64</sup>

The Uniform Code is designed to promote the impartiality of arbitral forums.<sup>65</sup> Originally, in disputes involving amounts greater than \$2500, the arbitration panels consisted of no less than three nor more than five arbitrators. The majority of panel members could not come from the securities industry unless the investors requested otherwise.<sup>66</sup> Recently, due to the increased number of disputes and amounts in controversy, several SROs have amended their rules to allow for a more flexible method of appointing panel members.<sup>67</sup> Additionally, parties may exclude arbitrators with or without cause.<sup>68</sup>

As the use of arbitration forums in securities disputes grew, the SEC expressed concern over the widespread and unrestricted use of pre-dispute arbitration clauses to compel arbitration.<sup>69</sup> The concern stemmed from the belief that most investors were unaware that they had a right to a judicial forum for securities claims.<sup>70</sup> In 1979 the SEC concluded that a broker's failure to bring the pre-dispute arbitration clause to the investor's attention may be fraudulent.<sup>71</sup> The

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63. This Conference was composed of 10 SROs (the American, Boston, Cincinnati, Midwest, New York, Pacific and Philadelphia Stock Exchanges, the Chicago Board Options Exchange, the Municipal Securities Rulemaking Board and the National Association of Securities Dealers, Inc.), the Securities Industry Association (a trade association for the industry), and three representatives of the general public. *Id.* at 548 n.155.

64. See *supra* note 27. The SEC approved the Code in 1979. Note, *supra* note 32, at 548.

65. To accomplish this, the Code incorporates several provisions not included in previous arbitral systems. Note, *supra* note 32, at 548.

66. *Id.*

67. See, e.g., Exchange Act Release No. 23,179 (April 28, 1986). The American Stock Exchange (AMEX) now has discretion to appoint a panel of three or five arbitrators in cases involving amounts less than \$500,000. Before this approved rule change, AMEX rules provided for a panel of three to five arbitrators in disputes involving amounts less than \$100,000 and a panel of five arbitrators in disputes involving amounts over \$100,000. When the amount in controversy exceeds \$500,000 the panel shall consist of five arbitrators.

68. Note, *supra* note 32, at 549. A party has a right to one peremptory challenge without providing a reason. For a concise description of the Code provisions, see Katsoris, *supra* note 1, at 285-86.

69. Agreements to submit existing disputes must be distinguished from agreements to submit future disputes. Under present law, investors may agree to submit existing disputes for arbitration. Katsoris, *supra* note 1, at 292. The primary rationale for voiding pre-dispute arbitration agreements is that deprivation of forum or recovery choice does not apply to agreements to arbitrate existing disputes because, in the latter, an investor knows his claim and can intelligently evaluate available forums and recovery methods before agreeing to arbitration. Note, *supra* note 3, at 102; see also Katsoris, *supra* note 1, at 294-95.

70. Note, *supra* note 32, at 549. This concern arose from the SEC's belief that *Wilko v. Swan*, 346 U.S. 427 (1953), had secured investors' right to a judicial forum. See *infra* note 77.

71. Peloso, *supra* note 60, at 950. See Sec. Exchange Act Release No. 15,984 [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,122 (July 2, 1979). The Release suggests that the unfairness to the investor lay in the use of pre-printed forms without



negative industry reaction to this SEC opinion and the continued use of the clauses without disclosure prompted the SEC to enact rule 15c2-2.<sup>72</sup>

The substance of rule 15c2-2 is twofold. First, the rule prohibits brokers from entering into agreements purportedly binding investors to arbitration.<sup>73</sup> Second, the rule requires brokers to send disclosure statements to investors who entered into such agreements prior to the rule's effective date of December 28, 1983. Under rule 15c2-2, these statements must inform investors that brokers cannot compel arbitration of federal securities law claims.<sup>74</sup> However, in enacting the rule, the SEC merely assumed the validity of the decisional law upon which it based this rule.<sup>75</sup> It is this assumption which requires close scrutiny.

### *The Wilko Doctrine: Exclusive Federal Jurisdiction*

Section 14 of the 1933 Act voids any "condition, stipulation or provision" requiring an investor "to waive compliance with any provision of this sub-chapter," any SEC rule, or regulation.<sup>76</sup> In the 1953 decision of *Wilko v. Swan*,<sup>77</sup> the Supreme Court defined the effect of the section 14 antiwaiver provision on pre-dispute arbitration agreements.

In *Wilko*, an investor alleged broker misrepresentation in violation of section 12(2) of the 1933 Act.<sup>78</sup> The brokerage firm moved for arbitration under a pre-dispute arbitration clause in the parties' investment contract. The district court held that arbitration denied the investor the "advantageous court remedy afforded" by the 1933 Act.<sup>79</sup> The Second Circuit Court of Appeals reversed, and held that the 1933 Act did not prohibit a prior agreement to refer disputes to arbitration.<sup>80</sup>

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disclosure. Hence, disclosure may remedy the SEC's concern. Peloso, *supra* note 60, at 950.

72. 17 C.F.R. § 240.15c2-2 (1985).

73. *See id.*

74. *See id.* This disclosure requirement is based upon the SEC's understanding of *Wilko*, 346 U.S. 427. *See infra* note 77. The rule, however, is "procedural, providing only for notice to the customer, and [it] does not act substantively to prevent arbitration of all federal [securities] claims." *Steinberg v. Illinois Co.*, 635 F. Supp. 615, 617 (E.D. Ill. 1986) (citing *Shotto v. Laub*, 632 F. Supp. 516, 527 (D. Md. 1986)).

75. Peloso, *supra* note 60, at 950.

76. Securities Act of 1933 § 14, 15 U.S.C. § 77n (1982).

77. 346 U.S. 427 (1953).

78. *Id.*

79. *Wilko*, 346 U.S. at 430.

80. *Wilko v. Swan*, 201 F.2d 439, 445 (2d Cir. 1953).

The Supreme Court reversed, holding that section 12(2) claims were not arbitrable. The Court reasoned that, to protect investors from fraud, “[section] 12(2) created a special right to recover for misrepresentation which differs substantially from the common-law action.”<sup>81</sup> For misrepresentation claims at common law, proof of scienter, the “intent to deceive, manipulate or defraud,”<sup>82</sup> was the plaintiff’s burden. Under section 12(2), however, the *broker* has the burden of proving *lack* of scienter. Hence, section 12(2) in effect imposes liability without a showing of scienter — a plaintiff need only prove “a negligent misstatement or omission.”<sup>83</sup>

The Court also stated that the arbitration agreement in *Wilko* was contrary to section 22(a) of the 1933 Act.<sup>84</sup> Section 22(a) provides that an aggrieved party may bring suit “in any court of competent jurisdiction — federal or state — and removal from a state court is prohibited.”<sup>85</sup> Under the antiwaiver provision (section 14) of the 1933 Act, investors may not waive compliance with the expansive forum selection provided by section 22(a). The Court ruled that the arbitration agreement in *Wilko* violated section 14 because the agreement amounted to a stipulation binding the investor to waive compliance with section 22(a).<sup>86</sup> Essentially, the agreement precluded the investor from bringing his claim before a court.

Consequently, the Court concluded that the three sections of the 1933 Act — section 12(2), the antifraud provision; section 14, the antiwaiver provision; and section 22(a), the forum selection provision — interfaced to justify the invalidation of the arbitration agreement.<sup>87</sup> The Court was confronted with competing policies: investor protection under the securities laws and enforcement of private arbitration agreements under the Federal Act. The Court determined that, in enacting the 1933 Act, Congress “created an exception to the federal mandate” of arbitration and the “intention of Congress concerning the sale of securities under the 1933 Act was best effectuated by holding the arbitration agreement invalid.”<sup>88</sup> The *Wilko* exception to the Federal Act, however, does not apply to disputes between members of a national securities exchange (“member-to-

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81. *Wilko*, 346 U.S. at 431.

82. *Hochfelder*, 425 U.S. at 193.

83. *Phillips v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 795 F.2d 1393, 1398 n.14 (8th Cir. 1986) (quoting *Berger v. Bishop Inv. Corp.*, 695 F.2d 302, 308 (8th Cir. 1982)).

84. Securities Act of 1933 § 22(a), 15 U.S.C. § 77v(a) (1982).

85. *Wilko*, 346 U.S. at 434-35. Additionally, section 22(a) provides for national service of process. Katsoris, *supra* note 1, at 294.

86. *Wilko*, 346 U.S. at 431.

87. *See Bob Ladd, Inc. v. Adcock*, 633 F. Supp. 241 (E.D. Ark. 1986).

88. *Wilko*, 346 U.S. at 438; *see also* Katsoris, *supra* note 1, at 294 (the three provisions “implicitly repealed” the Federal Act with regard to the 1933 Act securities claims).

member controversies")<sup>89</sup> or to disputes which involve only "knowledgeable" persons, that is, sophisticated investors and brokers who deal at arm's length.<sup>90</sup> The exception applies only to ordinary investor-broker disputes.

### *Wilko as Applied to the 1934 Act*

After the *Wilko* decision, the issue arose as to whether the invalidity of the pre-dispute arbitration provisions also would apply to section 10(b) disputes under the 1934 Act. Section 10(b) provides in pertinent part: "It shall be unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of" SEC rules and regulations.<sup>91</sup> This section and SEC rule 10b-5<sup>92</sup> promulgated thereunder are "catchall" antifraud provisions.<sup>93</sup>

Many courts expanded the *Wilko* doctrine to invalidate pre-dispute arbitration agreements in claims alleging section 10(b) violations.<sup>94</sup> These courts relied on the similarity of the antiwaiver provisions of the 1933 and 1934 Acts,<sup>95</sup> rejecting the Supreme Court's subsequent suggestions that *Wilko* should not be expanded to the 1934 Act.

In *Scherk v. Alberto-Culver Corp.*,<sup>96</sup> the Supreme Court outlined a "colorable argument" that *Wilko* does not apply to section 10(b) actions, drawing distinctions between the provisions of the two Acts.<sup>97</sup> Unlike section 12(2) of the 1933 Act, which provides an express private right of action, actions based upon section 10(b) and rule 10b-5 merely are implied. The Court noted that no "statutory counterpart" to section 12(2) exists in the 1934 Act, and neither section 10(b) nor rule 10b-5 "speaks of a private remedy to redress violations."<sup>98</sup>

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89. Peloso, *supra* note 60, at 947.

90. *Id.*

91. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b)(1982).

92. 17 C.F.R. § 240.10b-5 (1985).

93. *Chiarella v. United States*, 445 U.S. 222, 234-35 (1980).

94. *See, e.g., Starkman v. Seroussi*, 377 F. Supp. 518, 522 (S.D.N.Y. 1974); *Moran v. Paine, Webber, Jackson & Curtis, Inc.*, 389 F.2d 242, 245 (3d Cir. 1968). This Comment focuses only upon the applicability of *Wilko* to section 10(b) actions and does not address *Wilko's* applicability to additional violations of the 1934 Act.

95. *Katsoris, supra* note 1, at 300. Compare 15 U.S.C. § 78cc(a)(1982) with 15 U.S.C. § 77n (1982).

96. 417 U.S. 506 (1974), *reh'g denied*, 419 U.S. 885 (1974).

97. *Id.* at 514.

98. *Id.* at 513.

Additionally the 1934 Act does not establish the “special right” to recover for misrepresentations without proving scienter.<sup>99</sup> Unlike section 12(2) of the 1933 Act, proof of scienter is an “indispensable ingredient” in successful section 10(b) and rule 10b-5 actions.<sup>100</sup> Furthermore, while the Acts contain similar antiwaiver provisions,<sup>101</sup> certain provisions of the 1933 Act that the *Wilko* Court found could not be waived by an arbitration agreement “find no counterpart” in the 1934 Act. Specifically, the Court focused on the jurisdictional provisions of the 1933 Act.<sup>102</sup> Under section 22(a) of the 1933 Act,<sup>103</sup> an action could be brought in “any court of competent jurisdiction — federal or state — and removal from state court was prohibited.”<sup>104</sup> The 1934 Act provides for action only in the federal district courts having “exclusive jurisdiction,”<sup>105</sup> thus “significantly restricting Plaintiff’s choice of forum.”<sup>106</sup> The 1934 Act does not provide for the expansive forum selection of the 1933 Act. Hence, the forum selection provision so jealously guarded by the *Wilko* Court does not exist in the 1934 Act. Nevertheless, a few courts have suggested that *Scherk* “merely carves out a narrow exception to the *Wilko* holding” and applies “only to international transactions.”<sup>107</sup>

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99. *Id.* at 514.

100. *Berger v. Bishop Inv. Corp.*, 695 F.2d 302, 309 (8th Cir. 1982). The degree of proof in such actions is preponderance of the evidence. Comment, *Securities Fraud: A Supreme Court Prospectus of the 10(b) Action*, 29 LOY. L. REV. 1101, 1110 (1983). The Supreme Court in *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983), rejected the clear and convincing standard, noting that modern commodities dealings had little to do with common-law fraud actions requiring the clear and convincing standard. Because the preponderance of evidence standard is sufficient to establish liability in civil suits for money damages, in SEC actions to establish fraud under section 17(a) of the 1933 Act, in administrative proceedings before the SEC, and by district courts in section 10(b) actions, this standard is appropriate for modern securities suits. *Id.* To succeed in such actions, the investor must establish: (1) that the broker acted in violation of the section or rule (A broker violates the provisions if he employs a device, scheme or artifice to defraud, makes misrepresentations or omissions of material facts, or engages in acts, practices or conduct of business that operates as fraud or deceit. *Harris v. Union Elec. Co.*, 787 F.2d 355, 362 (8th Cir. 1986)); (2) causation (Causation, the “single most predominate factor running through” section 10(b) and rule 10b-5 claims, is either “transaction” causation, relating to the actual purchase or sale of securities, or “loss” causation, relating to the cause of the loss. Crane, *An Analysis of Causation Under Rule 10b-5*, 9 SEC. REG. L.J. 99 (1981). The key elements of transaction causation are reliance, materiality and due diligence. *Id.* at 111-20. Loss causation involves manipulation, insider trading or misrepresentation or omissions. *Id.* at 121-30.); (3) damages; and (4) that the fraudulent activity occurred “in connection with the purchase or sale of securities.” *Harris*, 787 F.2d at 362.

101. *See supra* note 95.

102. *Scherk*, 417 U.S. at 514.

103. Securities Act of 1933 § 22(a), 15 U.S.C. § 77v (1982).

104. *Wilko*, 346 U.S. at 431.

105. Securities Exchange Act of 1934 § 27, 15 U.S.C. § 78aa (1982).

106. *Scherk*, 417 U.S. at 514. For a concise discussion of the differences between the two Acts, see Katsoris, *supra* note 1.

107. Katsoris, *supra* note 1, at 299 n.143. Courts rejecting the *Scherk* Court’s

The distinctions noted by the *Scherk* Court were reiterated by Justice White in his concurring opinion in *Dean Witter Reynolds, Inc. v. Byrd*.<sup>108</sup> Justice White noted the absence of the "special right" and express remedy in the 1934 Act,<sup>109</sup> as well as the narrower jurisdictional provisions. He warned against "mechanically transplant[ing]" *Wilko's* reasoning to the 1934 Act,<sup>110</sup> concluding that the issue of arbitrability of section 10(b) actions remains "open."<sup>111</sup> Moreover, "in interpreting an implied cause of action . . . a finding of Congressional intent to create an exception to the [Fed-

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"colorable argument" include *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1030 (6th Cir. 1979); *Weissbach v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831, 835 (7th Cir. 1977); see also *Ayers v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532, 536 n.12 (3d Cir.), cert. denied, 429 U.S. 1010 (1976) (because the antiwaiver provisions of the Acts are nearly identical and under *Wilko* the 1933 Act provision prohibits pre-dispute arbitration agreements as equalling a waiver, the 1934 Act provision also prohibits such agreements). Additionally, the *Ayers* court noted the apparent acceptance by Congress that *Wilko* applies to section 10(b) claims. *Ayers*, 538 F.2d at 537 (citing H.R. REP. NO. 229, 94th Cong., 1st Sess. 111, reprinted in 1975 U.S. CODE CONG. & ADMIN. NEWS, 321, 342).

108. 470 U.S. 213, 224 (1985) (White, J., concurring). In addition to federal securities law claims, investors often allege state and common-law violations. State claims commonly involve breaches of contract or fiduciary duties. Common-law claims often are claims of fraud. Note, *supra* note 32, at 541. Faced with the issue whether these pendent state claims could be arbitrated, the Supreme Court in *Byrd*, espousing the strong federal policy favoring arbitration, held that, when federal securities and state law claims arising out of the same facts are joined and a valid arbitration agreement exists, the state claims must be arbitrated. *Byrd*, 470 U.S. at 217; see also Brodsky, *Arbitration in Securities Cases*, N.Y.L.J., June 5, 1986, at 1, col. 1. The Supreme Court rejected both the "intertwining" doctrine and the "bifurcated approach" utilized by lower courts to decide the issue. *Byrd*, 470 U.S. at 222. The "intertwining" doctrine mandated that courts deny arbitration of all claims, federal and state, under the arbitration prohibition of *Wilko*, and preserve federal jurisdiction when the claims were so intertwined as to make severability difficult or impossible. *Sibley v. Tandy Corp.*, 543 F.2d 540, 543 (5th Cir. 1976) The *Sibley* court, however, determined that the case facts were not so intertwined to prevent separation. *Id.* at 543-44.

Under the "bifurcation" approach, state claims are stayed pending judicial resolution of the federal claims. *Dickinson v. Heinold Sec. Inc.*, 661 F.2d 638, 644 (7th Cir. 1981). Ultimately, the Supreme Court declined to decide whether section 10(b) and rule 10b-5 securities claims could be arbitrated, determining that the issue was not properly before the Court. *Byrd*, 470 U.S. at 215-16 n.1.

109. See *Byrd*, 470 U.S. 213, 225 (White, J., concurring) (*Wilko's* "solicitude for the federal cause of action is not necessarily appropriate where the cause of action is judicially implied").

110. *Id.* at 224.

111. *Id.* at 225; see also *Bob Ladd, Inc. v. Adcock*, 633 F. Supp. 241 (E.D. Ark. 1986). *Bob Ladd* noted that courts applying the *Wilko* doctrine to claims under the 1934 Act do so in a rather "mechanical fashion" with little regard for the specific claim being set forth" and those courts which have declined to apply *Wilko* recognize the differences between the 1933 and 1934 Acts. *Id.* at 243.

eral] Act may not be warranted"<sup>112</sup> as was found in *Wilko*.<sup>113</sup> In *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*,<sup>114</sup> decided shortly after *Byrd*, the Supreme Court rejected the argument that the importance of a statutory scheme, as determined by a court, could outweigh the important policy of the Federal Act to enforce private contractual arbitration agreements.<sup>115</sup>

Esponsing Justice White's concurring opinion, several recent court decisions have held section 10(b) actions to be arbitrable.<sup>116</sup> Some courts, however, continue to apply *Wilko* to securities claims, pointing to a variety of justifications for doing so. In *Conover v. Dean Witter Reynolds, Inc.*,<sup>117</sup> the Ninth Circuit Court of Appeals determined that the three reasons favoring nonarbitrability of section 12(2) claims apply "with equal force" to section 10(b) actions: (1) investors are subject to overbearing brokers; (2) judicial discretion is required to ensure full protection of the Acts; and (3) because the Acts provide special protections to investors, investors surrender more by agreeing to submit claims to arbitration than individuals who agree to submit routine business transaction claims to arbitration.<sup>118</sup>

### BALANCING COMPETING POLICIES

In the securities industry, the strong federal policy favoring arbitration purportedly conflicts with the investor protection policy of the

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112. *Jacobson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 797 F.2d 1197, 1204 (3d Cir. 1986) (Adams, J., concurring and dissenting) (citing *Scherk*, 417 U.S. at 513-14); see also Katsoris, *supra* note 1, at 300-01 ("It is illogical to insist that the general nonwaiver provision of the Exchange Act overrides the [Federal] Act in the same manner as section 14 of the Securities Act, when the Exchange Act's nonwaiver provision is not buttressed by special rights and broad jurisdictional provisions similar to those found in the Securities Act.").

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

114. 105 S. Ct. 3346 (1985).

115. *Id.*

116. See, e.g., *Phillips*, 795 F.2d 1393; *Schriner v. Bear, Stearns & Co.*, 635 F. Supp. 373 (N.D. Cal. 1986); *Bob Ladd, Inc. v. Adcock*, 633 F. Supp. 241 (E.D. Ark. 1986). Term Resources I v. Burgin, [1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,703 (S.D.N.Y. April 1, 1986). *Contra* *Conover v. Dean Witter Reynolds, Inc.*, 794 F.2d 520 (9th Cir. 1986) (petition for certiorari filed August 29, 1986); *McMahon v. Shearson/American Express, Inc.*, 788 F.2d 94 (2d Cir.), *cert. granted*, 107 S. Ct. 60 (1986); *Shapiro v. Merrill Lynch & Co.*, 634 F. Supp. 587 (S.D. Ohio 1986).

117. 794 F.2d 520 (9th Cir. 1986).

118. *Id.* at 525 (citing *Wilko*, 346 U.S. at 431-33, 435-37).

Additionally, a loss of substantive rights is feared if section 10(b) actions are arbitrated. Justice Douglas, in his dissenting opinion in *Scherk*, expressed concern that (a) subjective findings of knowledge and purpose will be ill-determined by arbitrators without judicial instruction on the law; (b) arbitration awards are made without an explanation of reasons or a record, making the arbitrator's conception of the statutory scheme unreviewable; (c) extensive pre-trial discovery is not available; and (d) the wide venue choice provided by the 1934 Act, 15 U.S.C. § 78aa (1982), would be lost. 417 U.S. at 532 (Douglas, J., dissenting).

securities laws. However, nothing indigenous to the securities laws makes arbitration inappropriate.<sup>119</sup> Arguably, buyers and sellers of securities occupy unequal bargaining positions. The Supreme Court emphasized this potential inequality when invalidating the *Wilko* investment contract arbitration clause. This unequal bargaining position argument used to invalidate investment contract arbitration clauses applies with equal persuasiveness to areas outside the securities industry.<sup>120</sup> Investment contracts are a type of commercial contract, and many commercial contracts are executed by parties in unequal bargaining positions. Though these contracts often contain standard pre-printed arbitration clauses<sup>121</sup> similar to those contained in investment contracts, the commercial contract arbitration clauses are not void because of the existing inequality. If courts could invalidate arbitration clauses in investment contracts because of the bargaining inequality, courts could invalidate arbitration clauses in *all* commercial contracts in which the bargaining power between the parties was unequal. This potentially unlimited invalidation would undermine the strong federal policy favoring arbitration by practically eliminating arbitration clauses and hence the availability of arbitration to parties who desire a more efficient resolution of disputes but who happen to occupy unequal bargaining positions. Both the federal policy favoring arbitration and the securities law investor protection policy can be achieved by means less devastating to arbitration.

### *Increased Judicial Review*

A perceived lack of judicial involvement in arbitration awards has fostered fears that arbitration does not adequately protect investors. Judicial involvement in arbitration, however, is limited, but not lacking.<sup>122</sup> Judicial review is restricted by federal and state statutes to motions to vacate, modify, or resubmit an award.<sup>123</sup> An award may

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119. Sterk, *supra* note 16, at 520.

120. *Id.* at 517.

121. *Id.* at 518. Moreover, because the securities laws were designed to protect investors and restore public confidence in the securities market, the laws succeed by adjusting the legal rights of the parties to better work justice between them, and "public policy furnishes no reason to refuse enforcement of arbitration clauses" in securities investment contracts. *Id.* at 519.

122. Judicial enforcement of an award consists of entering judgment on the award. Widiss, *Judicial Enforcement and Review of Arbitration Awards*, 14 BRIEF 37 (1985). This procedure essentially is automatic when the noncomplying party to an award does not object to the requested enforcement. *Id.* at 38.

123. Both the Federal Act and the Uniform Act provide limited grounds for vacat-

be challenged only upon statutorily specified grounds.<sup>124</sup>

In practice, courts are reluctant to interfere in an arbitrator's decision.<sup>125</sup> Judicial review may be permitted for "manifest disregard" of the law.<sup>126</sup> And, when the parties provide in the agreement to arbitrate the dispute pursuant to specified law, or when an arbitrator declares that his determination was made pursuant to law which he specified, the application of that law may be reviewed by a court.<sup>127</sup>

A growing trend in recent years favors more extensive judicial review of arbitration awards. Courts are no longer as reluctant as in the past to apply available statutory standards to review the merits of an arbitrator's decision.<sup>128</sup> With increased frequency, judges are vacating awards on public policy grounds<sup>129</sup> and concluding that arbitrators exceeded the scope of the arbitration agreement.<sup>130</sup> This trend is no doubt welcomed by those who fear that arbitration does not offer adequate protection.

The increased use of judicial review furthers investor protection while preserving the benefits of invoking the arbitration process. In-

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ing an award. An award will be vacated if the award was procured by corruption, fraud or undue means, if one or more arbitrators was evidently partial or corrupt, if one or more of the arbitrators was guilty of misconduct in refusing to postpone the hearing or hear pertinent or material evidence, or if any other misconduct by which the rights of any party were prejudiced, or if one or more arbitrators exceeded their powers or so imperfectly executed them that a mutual final and definitive award was not made. 9 U.S.C. § 10 (1982); UNIF. ARBITRATION ACT, 7 U.L.A. 20 (1985); see Comment, *supra* note 12, at 214. The statutes allow for modification or correction of an award if (1) an evident or material miscalculation or mistake occurred; (2) the award was made upon a matter not submitted or properly before the arbitrators; or (3) the award was imperfect in matters of form not affecting the merits of the dispute. 9 U.S.C. § 11 (1982); UNIF. ARBITRATION ACT, 7 U.L.A. 13 (1985); see Comment, *supra* note 12, at 214 n.129.

124. Comment, *supra* note 12, at 214 n.130; *San Martine Compania de Navegacion, S.A. v. Saguenay Terminals, Ltd.*, 293 F.2d 796 (9th Cir. 1961).

125. An award will not be opened unless "perverse misconstruction or positive misconduct" by an arbitrator is "plainly established" or the arbitration agreement provided otherwise. M. DOMKE, *THE LAW AND PRACTICE OF COMMERCIAL ARBITRATION* § 34:00 (Wilner rev. ed. 1984). "If the award is within the submission and contains the honest decision of the arbitrators, after a full and fair hearing of the parties, a court of equity will not set it aside for error, either in law or fact." *Burchell v. Marsh*, 58 U.S. (17 How.) 344, 349 (1854). Finality of the arbitration award is one of the principal advantages of arbitration. If awards were subject to judicial review for error, the arbitration process would be "neither speedy nor inexpensive." Sterk, *supra* note 24, at 482 n.6.

126. See M. DOMKE, *supra* note 125, § 25:05, at 396. Arbitrators "may not disregard the law." *Wilko*, 346 U.S. at 336, 340 (Frankfurter, J., dissenting). Any disregard would "constitute grounds for vacating the award pursuant to section 10" of the Federal Act. *Id.* (citing lower court opinion). Such disregard rarely occurs in practice. M. DOMKE, *supra* note 125, § 25:05, at 396.

127. M. DOMKE, *supra* note 125, § 25:05, at 396.

128. Widiss, *supra* note 122, at 39.

129. See generally *id.* at 38, 40.

130. *Id.* at 39. An arbitrator may not decide issues not expressly included in the arbitration agreement. *Id.* at 40-41. An agreement, however, to "arbitrate all disputes between us" usually will give an arbitrator general jurisdiction. *Bayer & Abrahams*, *supra* note 28, at 32.



vestors are given a greater assurance that courts will step in to protect them if arbitrators disregard the law. Parties to arbitration also are guaranteed the right to appeal a decision and may not waive this right.<sup>131</sup> The wholesale contractual elimination of court control over the arbitration process acts to invalidate an arbitration agreement.<sup>132</sup>

Despite the increased frequency of judicial review, the advantages of the arbitration process are preserved because judicial review remains heavily restricted by statute.<sup>133</sup> If review were to become less restricted, the arbitration process would lose several of its principal advantages. Routine review would make the process slow and inefficient, much the same as litigation. The frustrations and delays characteristic of litigation (caused by customary and frequent review of decisions) would be unfortunately injected into the arbitration process.

The current level of judicial review of arbitration awards is an acceptable balance of court involvement in and absence from the arbitration process. Investors are protected by the increased willingness of courts to review arbitration decisions when investors' rights appear to have been disregarded, but the arbitration process retains its advantages over traditional litigation because such judicial review remains limited by statute. While the current level of judicial review should be maintained, the discovery process in arbitration must be reformed to better protect investors.

### *Increased Discovery*

To assure fair and full adjudication of claims by knowing and considering all relevant facts, adequate discovery is imperative: the investment contract arbitration clause must provide for adequate discovery. The greater the arbitral forum's "ability to adjudicate securities claims fully and fairly, the less forceful is the proposition that arbitration is a 'waiver of compliance' with the securities laws."<sup>134</sup> Currently, discovery in arbitration is limited in order to circumvent the costs, delay, and complexity of traditional litigation.<sup>135</sup> The extent of discovery is usually the voluntary disclosure of documents and other evidence.<sup>136</sup> Arbitrators, however, are authorized to

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131. M. DOMKE, *supra* note 125, § 33:01, at 464.

132. *Id.*

133. *See supra* note 123 and accompanying text.

134. Peloso, *supra* note 60, at 950.

135. Willenken, *supra* note 28, at 182.

136. *See Katsoris, supra* note 1, at 285-89.

subpoena documents and witnesses under the contempt power.<sup>137</sup> The typical pre-dispute arbitration clause<sup>138</sup> does not provide specifically for discovery. A few courts, however, have granted pre-arbitration hearing discovery when the arbitrator determines it to be appropriate,<sup>139</sup> although this power “has been used sparingly and only in extreme circumstances.”<sup>140</sup>

The arbitration clause must provide for “all applicable discovery.”<sup>141</sup> Even to “boilerplate” arbitration provisions, discovery provisions should be added and insisted upon by the parties.<sup>142</sup> A typical investor who signs a pre-printed investment contract containing a standard arbitration clause often is unaware of the importance of or the need to ensure for adequate discovery. Investors may not even know that the contract contains an arbitration clause<sup>143</sup> or what protection arbitration will provide. The burden of providing for adequate discovery, therefore, should fall on the brokers by drafting discovery provisions into the arbitration clauses. Brokers may contend that the responsibility of protecting investors lies with the investors themselves. Adequate discovery, however, serves the dual purpose of protecting *both* investors and brokers by assuring that all facts necessary for a fair arbitral decision are “discovered” and considered by the arbitrator.

Because providing for “all applicable discovery” ultimately may lead to the extensive, burdensome and time-consuming discovery process associated with litigation,<sup>144</sup> discovery in arbitration must be confined pursuant to agreed-upon limitations. The Federal Rules of Civil Procedure provide an example of workable limitations on the amount and type of discovery allowed, and these limits could be adapted to fit the contours of arbitration.<sup>145</sup> Additionally, as one commentator has noted, “it would be helpful” if SROs who conduct the arbitration proceedings provided “optional rules for discovery

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137. See *supra* notes 28-29 and accompanying text.

138. See *supra* note 56.

139. Willenken, *supra* note 28, at 175-76.

140. Katsoris, *supra* note 1, at 287-88 n.52.

141. Schern, *Discovery and Case Preparation*, L.A. Daily J., Jan. 26, 1981, at 2, col. 5.

142. *Id.* at 5, col. 2.

143. See *supra* note 59 and accompanying text.

144. Extensive pre-trial discovery practiced by courts can be “unnecessarily expensive and burdensome,” Katsoris, *supra* note 1, at 287 n.52, resulting in “protracted” litigation. Willenken, *supra* note 28, at 181.

145. Willenken, *supra* note 28, at 186. Examples of discovery limits which could be provided for include: (1) discovery pursuant to the Federal Rules of Civil Procedure, excluding the taking of depositions of independent witnesses; (2) deposing of the two most knowledgeable persons who are officers, agents or employees of each party; (3) disposing of all related documentation; (4) permitting interrogatories to each party; or (5) procuring affidavits from each witness and a copy of each document that is expected to be used at the hearing. *Id.*

which could be included" in investment contracts.<sup>146</sup>

The investment contract is an "appropriate and proper place to provide for discovery in advance of arbitration."<sup>147</sup> Adequate discovery pursued within established limits will protect investors and brokers alike. Limited discovery will ensure the fair adjudication of securities claims to the benefit of all parties, while reducing the burdens of traditional discovery. This, in turn, will help preserve the efficient character of the arbitration process. Adequate discovery, however, will not protect investors against an arbitrator's failure to comply with the securities laws. To achieve maximum protection, a record of an arbitration proceeding must be maintained, and an opinion must be rendered.

### *Requirement of a Record or Opinion*

In practice, arbitrators are not required to write an opinion or state the reasons for an award.<sup>148</sup> Records of arbitration proceedings are not required *unless requested by the arbitrator or a party*.<sup>149</sup> Despite widespread belief that arbitrators maintain no record or opinion of securities arbitration proceedings, some sort of record is kept by most SROs hearing such disputes.<sup>150</sup> Most, however, must be expanded to "all" to fully protect investors. Justice Frankfurter, in his dissenting opinion in *Wilko*, called for the maintenance of "some" record or opinion, "however informal."<sup>151</sup> Requiring a relatively thorough, yet concise, record or opinion will protect both investors and the arbitration process.

A record or opinion also would help courts determine whether an arbitrator's decision should be reviewed, modified or vacated. The records or opinions would display arbitrator compliance or noncompliance with the law:<sup>152</sup> lack of compliance will "upset" an award.<sup>153</sup> The records and opinions, therefore, arm investors who question the propriety of an award with the artillery necessary to successfully obtain judicial review.

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146. *Id.* at 186.

147. *Id.* at 185.

148. *E.g.*, M. DOMKE, *supra* note 125, § 29:06, at 435-36; UNIF. CODE ARB. § 25; *see also* Bernhardt v. Polygraphic Co. of America, 350 U.S. 198, 203-04 n.4 (1956).

149. Katsoris, *supra* note 1, at 286 n.47 (emphasis added).

150. *Id.* If a party asks to have the record transcribed, he bears the costs. *Id.* *But see* Note, *supra* note 3, at 113 n.63.

151. *Wilko*, 346 U.S. at 440 (Frankfurter, J., dissenting).

152. *Id.*

153. In the record or opinion, arbitrator compliance with the law "will appear, or want of it will upset the award." *Wilko*, 346 U.S. at 440.

On the other hand, requiring lengthy or extensively detailed records of proceedings or opinions by arbitrators would destroy several of the attractive purported advantages of arbitration — informality, speed and relatively low costs. Requiring lengthy and extensive records or opinions would burden arbitration with the characteristics that make litigation difficult. Conceivably, proceedings might become more formal so that detailed records could be kept, and arbitration costs might increase since lengthy and detailed records and opinions are expensive to maintain and prepare. Eventually the maintenance and preparation of records and the ultimate drafting of extensive opinions would inflict upon arbitration proceedings the same delays and inordinate time expenditures peculiar to traditional litigation. To remove the informality, relative inexperience, and speed from arbitration proceedings would be to transform arbitration into litigation. The use of short, concise, but relatively thorough opinions and records, however, would avoid such an unfortunate transformation.

Records and opinions must be short and concise to quell concerns that arbitration efficiency will diminish if such devices are required. For example, in areas outside the securities field, arbitrators maintain records or deliver opinions. Labor arbitrators, for example, routinely deliver opinions with their awards<sup>154</sup> with no apparent loss of efficiency. The labor field, like the securities field, is complex. If labor arbitrators are able to resolve disputes, maintain records and deliver opinions without great efficiency loss, securities arbitrators can and must do the same. Moreover, any perceivable reduction<sup>155</sup> in efficiency is justified to protect investors and ensure arbitrator compliance with the law.<sup>156</sup>

Balancing the competing policies of protecting investors while encouraging arbitration continues to plague the Supreme Court. The issue of the arbitrability of section 10(b) actions under the 1934 Act remains undetermined, the Court having twice declined to address this issue. In October 1986, however, the Court, in an effort to resolve this nagging problem, granted review of a Second Circuit decision, *McMahon v. Shearson/American Express, Inc.*<sup>157</sup>

In *McMahon*, plaintiffs charged defendant Shearson with knowingly violating section 10(b) and rule 10b-5 by churning plaintiffs' accounts, making false statements, and omitting material facts.<sup>158</sup>

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154. Stephens, *Why Courts Overrule Arbitrators' Awards*, 36 LAB. L.J. 108, 109 (1985).

155. See *Sobel v. Hertz, Warner & Co.*, 469 F.2d 1211, 1215 (2d Cir. 1974).

156. See *supra* note 126 and accompanying text.

157. 788 F.2d 94 (2d Cir.), *cert. granted*, 107 S. Ct. 60 (1986).

158. *Id.* at 95. Additionally, plaintiffs alleged violations of the Racketeer Influenced Corruption Organization Act, 18 U.S.C. §§ 1961-1968 (1982). *Id.*

Shearson moved to compel arbitration under a clause in the parties' investment contracts. The district court granted the motion and ordered the federal securities law claims arbitrated.<sup>159</sup> The Second Circuit Court of Appeals reversed, holding that under *Wilko* and Second Circuit precedent, section 10(b) and rule 10b-5 claims were not arbitrable.<sup>160</sup> The stage, therefore, is set for the Court to deliver a landmark decision which hopefully will recognize arbitration as the favored alternative.

### CONCLUSION

The use of arbitration to resolve investor-broker disputes in the securities industry has increased dramatically. Pre-dispute arbitration clauses are standard features in investment contracts. Though the Federal Act mandates the enforcement of valid arbitration agreements, many courts have refused to enforce investment contract arbitration clauses, fearing that arbitration does not afford investors the extensive protection provided by the securities laws.

In *Wilko v. Swan*, the Supreme Court created an exception to the Federal Act by holding that securities law claims arising under the 1933 Act are not arbitrable. While several courts have applied the reasoning of *Wilko* to the 1934 Act, and thereby have held section 10(b) and rule 10b-5 claims to be nonarbitrable, others have restricted the application of *Wilko* to the 1933 Act. The Supreme Court twice refused to address the issue of the applicability of *Wilko* to section 10(b) and rule 10b-5 actions; however, in dicta the Court noted that application was doubtful due to the differences in provisions of the 1933 and 1934 Acts. *McMahon v. Shearson/American Express, Inc.* affords the Court an opportunity to resolve this issue.

Arbitration is no longer the "unwelcome stepchild" of the courts.<sup>161</sup> Arbitration offers several advantages over traditional litigation. Moreover, judicial review of awards, though restricted, is becoming more frequent due to a willingness by the courts to utilize statutory provisions. Adequate discovery is possible by drafting discovery provisions into arbitration clauses; requiring arbitrators to maintain concise but nonextensive records or opinions of their awards would not burden the arbitration process.<sup>162</sup> Because arbitra-

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159. *Id.*

160. *Id.* at 96.

161. Sterk, *supra* note 16, at 482.

162. One commentator has called for the establishment of convenient and permanent arbitration forums throughout the country to ensure fairness in accessibility to all

tion can effectively ensure adequate enforcement of the securities laws, arbitration of section 10(b) and rule 10b-5 claims should be allowed pursuant to a valid arbitration agreement.

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parties. Katsoris, *supra* note 1, at 312. Currently, much of the securities arbitration apparently occurs in New York (the National Association of Securities Dealers, Inc. and the New York Stock Exchange handle most arbitration proceedings), presenting problems for out-of-state claimants. *See supra* note 57.