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SECURITIES LITIGATION: THE UNSOLVED PROBLEM OF PREDISPUTE ARBITRATION AGREEMENTS FOR PENDENT CLAIMS

James C. Krause*

In 1953, the United States Supreme Court decided the landmark case of Wilko v. Swan and held that the Securities Act of 1933 rendered unenforceable agreements to arbitrate federal securities law claims arising out of disputes between investors and broker-dealers. Since that date, courts have been faced with complex questions when investors have sued broker-dealers for both non-arbitrable federal securities claims and arbitrable state law claims. Mr. Krause examines some of the problems presented by the current state of the law and proposes that the superior remedy of arbitration, if guaranteed to be fair, uniform, inexpensive, and efficient by statute or regulation, should be available to resolve all securities disputes. Mr. Krause further proposes that when such arbitration procedures are formulated, Wilko v. Swan should be overruled.

While arbitration as a mode of private dispute resolution was once considered with suspicion and distrust,¹ it is now lauded as a valuable and proper alternative to litigation.² With respect to arbitration of securities contro-

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1. As Congress noted in considering the Federal Arbitration Act:

The need for this law arises from an anachronism of our American law. Some centuries ago, because of the jealousy of the English courts for their own jurisdiction, they refused to enforce specific agreements to arbitrate upon the ground that the courts were thereby ousted from their jurisdiction. This jealousy was adopted by the American courts.

H.R. REP. NO. 96, 68th Cong., 1st Sess. 2 (1924). See, e.g., *W.H. Blodgett Co. v. Bebe Co.*, 190 Cal. 665, 667, 214 P. 38, 39 (1923) (agreement to arbitrate unenforceable as constituting an attempt to oust the court of jurisdiction); *Cocalis v. Nazilides*, 308 Ill. 152, 159-60, 139 N.E. 95, 98-99 (1923) (predispute agreement void as it deprives parties of right to resort to the courts as provided in the constitution); *Gauche v. Metropolitan Bldg. Co.*, 125 La. 530, 534-35, 51 S. 578, 579 (1910) (arbitration agreement not enforced because of court's fear of administrative difficulties in so doing); *Hurst v. Litchfield*, 39 N.Y. 377, 379 (1868) (predispute agreement void as tending to exclude the jurisdiction of the courts). See generally Comment, *Arbitration—A Viable Alternative?*, 1974-75 FORDHAM URB. L.J. 53.

2. See, e.g., *Madden v. Kaiser Foundation Hosps.*, 17 Cal. 3d 699, 706-08, 552 P.2d 1178, 1182-83, 131 Cal. Rptr. 882, 886-87 (1976); *Player v. George M. Brewster & Son, Inc.*, 18 Cal. App. 3d 526, 534, 96 Cal. Rptr. 149, 154 (1971); *Egell v. Rocky Mountain Bean & Elevator*

sies, the Securities Exchange Commission (SEC) has stated that the best interests of both investors and the securities industry demand a fully effective, yet inexpensive, system for dispute resolution.³ In fact, arbitration of investor-broker⁴ disputes in securities matters is gaining the increasing attention of the legal community.⁵

Although under the present law, an investor may agree to submit an existing controversy with a broker-dealer to arbitration,⁶ a predispute arbitration provision⁷ is not enforceable against an investor for claims arising under the Securities Act of 1933 (Securities Act),⁸ the Securities Exchange Act of 1934 (Exchange Act),⁹ or the regulations promulgated pursuant to these statutes.¹⁰ This bar to the compelled arbitration of securities claims rests upon provisions of the federal securities acts designed to protect investors from waiving the valuable right to seek damages in the federal courts¹¹ for securities law violations.

The prohibition of predispute arbitration agreements does not, however, extend to state claims arising from securities transactions but not based upon federal securities law.¹² Instead, the arbitrability of claims arising under state statutory or common law is determined solely by reference to either

Co., 76 Colo. 409, 411-12, 232 P. 680, 681 (1925); *S.M. Wolff Co. v. Tulkoff*, 9 N.Y.2d 356, 362, 214 N.Y.S.2d 374, 377, 174 N.E.2d 478, 480 (1961). Forty states, the District of Columbia, and the federal government have enacted statutes providing for the enforcement of predispute arbitration agreements. See A. WIDISS, *ARBITRATION* 343-44 (1979) (listing these states with citations to statutes). Indeed, Chief Justice Burger has stated that "[t]here are a great many problems that should not come to judges at all, and can be disposed of in other ways, better ways. . . . [O]ne basic way . . . is the use of private arbitration." *FORBES*, July 1, 1971, at 21.

3. Securities Exchange Act Release No. 12974, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,807, at 87,105.

4. An investor-broker relationship exists between a private person and a "broker-dealer" registered with a national securities exchange or with the Securities and Exchange Commission (SEC) pursuant to § 15(a)(1) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. § 78o(a)(1) (1976).

5. See, e.g., Neville, *The Enforcement of Arbitration Clauses in Investor-Broker Agreements*, 34 *ARB. J.* 5 (1979); Comment, *Arbitration of Investor-Broker Disputes*, 65 *CALIF. L. REV.* 120 (1977); Note, *Enforceability of Arbitration Agreements in Fraud Actions Under the Securities Act*, 62 *YALE L.J.* 985 (1953).

6. *Tullis v. Kohlmeyer Co.*, 551 F.2d 632, 637 (5th Cir. 1977); *Coenen v. R.W. Presspich & Co.*, 453 F.2d 1209, 1213 (2d Cir. 1972); *Gardner v. Shearson, Hammill & Co.*, 433 F.2d 367, 368 (5th Cir. 1970), cert. denied, 401 U.S. 978 (1971); *Moron v. Paine, Webber, Jackson & Curtis*, 389 F.2d 242, 246 (3d Cir. 1968).

7. This Article is concerned solely with predispute arbitration agreements—agreements to submit future disputes to persons outside the judicial process for resolution. Submission agreements—agreements to submit existing controversies to arbitration—are beyond the scope of this Article.

8. 15 U.S.C. § 77a-77aa (1976). See notes 46-75 and accompanying text *infra*.

9. 15 U.S.C. §§ 78a-78kk (1976). See notes 61-75 and accompanying text *infra*.

10. See note 66 and accompanying text *infra*.

11. See text accompanying notes 46-58 *infra*.

12. See *DeHart v. Moore*, 424 F. Supp. 55, 56 (S.D. Fla. 1976) (state law claims arising from securities transaction arbitrable under arbitration clause in binding agreement pursuant to Federal Arbitration Act); *Stockwell v. Reynolds & Co.*, 252 F. Supp. 215, 220 (S.D.N.Y. 1965) (common law securities claims arbitrable under Federal Arbitration Act).

state arbitration law¹³ or the Federal Arbitration Act.¹⁴ Because the Federal Arbitration Act applies to claims arising from transactions involving interstate commerce,¹⁵ and because securities dealings usually involve such transactions,¹⁶ state securities claims are normally arbitrable. Yet, when arbitrable state securities claims are joined with nonarbitrable Securities Act or Exchange Act claims, the question arises whether these pendent state claims are still subject to arbitration.

Although the courts have reached no consensus,¹⁷ it is important, for several reasons, to determine whether these pendent state law claims remain arbitrable. If they are arbitrable, all questions regarding punitive damages will be removed from the federal action because punitive damages are recoverable only under state law.¹⁸ In addition, because in some jurisdictions

13. See cases cited in note 2 *supra*. Of the 40 states that have enacted statutes providing for the enforcement of predispute arbitration agreements, 19 have enacted the Uniform Arbitration Act. See A. WIDISS, *ARBITRATION* 343-44 (1979). Most of the other 21 states have enacted laws substantially similar to the Uniform Arbitration Act. *Id.* at 225. The seminal provision of the Act provides:

A written agreement to submit any existing controversy to arbitration or a provision in a written contract to submit to arbitration any controversy thereafter arising between the parties is valid, enforceable and irrevocable, save upon such grounds as exist at law or in equity for the revocation of any contract. This act also applies to arbitration agreements between employers and employees or between their respective representatives [unless otherwise provided in the agreement].

Uniform Arbitration Act § 1, 7 UNIFORM LAWS ANN. 4 (1978).

14. 9 U.S.C. §§ 1-14 (1976). See text accompanying notes 22-25 *infra*.

15. See notes 23-24 and accompanying text *infra*.

16. For example, if an investor-broker transaction satisfied any of the criteria listed in section 12(2) of the Securities Act, 15 U.S.C. § 77l(2) (1976), so as to be within the jurisdiction of that Act, see note 48 *infra*, the transaction (contract) would also be subject to the Federal Arbitration Act.

17. Compare the discussion of *Machiavelli v. Shearson, Hammill & Co.*, 384 F. Supp. 21 (E.D. Cal. 1974), and *DeHart v. Moore*, 424 F. Supp. 55 (S.D. Fla. 1976), in text accompanying notes 102-120 *infra*, with the discussion of *Shapiro v. Jaslow*, 320 F. Supp. 598 (S.D.N.Y. 1970), and *Sibley v. Tandy Co.*, 543 F.2d 540 (5th Cir. 1976), *cert. denied*, 434 U.S. 824 (1977), in text accompanying notes 132-137 *infra*.

18. The damages sections of the Securities Act, §§ 11(e), 12(2), 15 U.S.C. §§ 77k(e), 77l(2) (1976), do not provide for the recovery of punitive damages. See *Avern Trust v. Clarke*, 415 F.2d 1238, 1242 (7th Cir. 1969); *Schaefer v. First Nat'l Bank*, 326 F. Supp. 1186, 1193 (N.D. Ill. 1970), *appeal dismissed*, 465 F.2d 234 (7th Cir. 1972). In addition, punitive damages are not allowed under the implied cause of action found in section 17(a) of the Securities Act, 15 U.S.C. § 77q(a) (1976). See *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1283-86 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

Punitive damages are also not recoverable under the Exchange Act by virtue of § 28(a), 15 U.S.C. § 78bb(a) (1976), which provides that no one shall recover "a total amount in excess of his actual damages." See *Straub v. Vaismon & Co.*, 540 F.2d 591, 599 (3d Cir. 1976) (no punitive damages under rule 10b-5); *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761, 781 (3d Cir. 1976) (no punitive damages under section 14(a) of the Exchange Act); *Green v. Wolf Corp.*, 406 F.2d 291, 302 (2d Cir. 1968) (damages limited to actual damages under rule 10b-5), *cert. denied*, 395 U.S. 977 (1969).

Punitive damages are, however, generally allowed under state law for claims involving securities violations. See, e.g., *Flaks v. Koegel*, 504 F.2d 702, 707 (2d Cir. 1974); *Globus v. Law*

a principal's liability for the acts of his or her agent is greater under state law than under the federal securities laws,¹⁹ it is important in measuring a broker-dealer's liability to determine whether the pendent claims will be tried jointly with the federal securities claims or will be severed for arbitra-

Research Serv., Inc., 287 F. Supp. 188, 192 (S.D.N.Y.), *aff'd in part and rev'd in part*, 418 F.2d 1276, 1283 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

19. Under state law, the liability of a principal for the acts of his or her agent is measured by the common law theory of respondeat superior. *See* *United States v. Fox Lake State Bank*, 240 F. Supp. 720, 722 (N.D. Ill. 1965), *modified*, 366 F.2d 962 (7th Cir. 1966); *Tollett v. Montgomery Real Estate & Ins. Co.*, 238 Ala. 617, 621, 193 So. 127, 129 (1940); *Lipscomb v. Coppage*, 44 Ill. App. 2d 430, 430p, 197 N.E. 2d 48, 56 (1964). Under respondeat superior, an employer is liable for the tortious acts of an employee done in the course and scope of employment or within the employee's authority or apparent authority, regardless of the employer's intent, knowledge, negligence, or good faith. *Gleason v. Seaboard Air Line Ry.*, 278 U.S. 349, 356 (1929); *Burger Chef Systems, Inc. v. Govro*, 407 F.2d 921, 925 (8th Cir. 1969); *SEC v. Lum's, Inc.*, 365 F. Supp. 1046, 1062-64 (S.D.N.Y. 1973).

Under federal securities law, the liability of a principal is measured by the "controlling person" standard. The Securities Act provides that a person is liable to the same extent as is a person he or she "controls," "unless the controlling person has no knowledge of, or reasonable ground to believe in, the existence of the facts by reason of which the liability of the controlled person is alleged to exist." Securities Act § 15, 15 U.S.C. § 77 (1976). Under the Exchange Act a person is liable to the same extent as a person he or she "controls," "unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." Exchange Act § 20(a), 15 U.S.C. § 78t(a) (1976). In practice, "good faith" can be demonstrated by a showing that the broker-dealer adequately supervised the employee in conformance with guidelines of the New York Stock Exchange and the National Association of Securities Dealers. *See, e.g., Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 438 (N.D. Cal. 1968), *modified*, 430 F.2d 1202 (9th Cir. 1970).

The essential difference between the controlling person theory and respondeat superior is that while respondeat superior imposes, in effect, absolute liability upon a broker-dealer for the acts of an employee, the controlling person theory of vicarious liability imposes liability only if the broker-dealer has been somewhat at fault. *See Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973) (culpable participation by broker-dealer required before liability imposed under § 20(a)); *SEC v. Lum's, Inc.*, 365 F. Supp. 1046, 1062-64 (S.D.N.Y. 1973) (at least negligent conduct of broker-dealer required before liability imposed).

The circuit courts of appeals differ regarding whether respondeat superior or the controlling person doctrine apply in measuring the liability of a broker-dealer for the acts of an employee. The controlling person provisions have supplanted the theory of respondeat superior in the Third, Eighth, and Ninth Circuits. *Gould v. American Hawaiian S.S. Co.*, 535 F.2d 761 (3d Cir. 1976); *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880 (3d Cir. 1975), *cert. denied*, 425 U.S. 993 (1976); *Zweig v. Hearst Corp.*, 521 F.2d 1129 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975); *Klapmeier v. Telecheck Int'l, Inc.*, 482 F.2d 247 (8th Cir. 1973). Depending on the closeness of the relationship between the controlling and controlled persons, the Second, Sixth, and Seventh Circuits may apply either controlling person liability or respondeat superior. *See SEC v. Geon Indus., Inc.*, 531 F.2d 39 (2d Cir. 1976); *Sennott v. Rodman & Renchaw*, 474 F.2d 32 (7th Cir.), *cert. denied*, 414 U.S. 926 (1973); *Halloway v. Howerdd*, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,629 (6th Cir. 1976). The Fourth and Fifth Circuits use respondeat superior exclusively. *See, e.g., Canas v. Burns*, 516 F.2d 251 (4th Cir. 1975); *Bird v. Ferry*, 497 F.2d 112 (5th Cir. 1974). *See generally* Comment, *A Comparison of Control Person Liability and Respondeat Superior: Section 20(a) of the Securities and Exchange Act*, 15 CAL. W.L. REV. 152 (1979).

tion.²⁰ Furthermore, if the state claims are severed from the federal claims, arbitration conducted before trial may resolve all questions to the parties' satisfaction, which, as a result, could preclude the need to adjudicate any of the federal securities claims.²¹

Because arbitration under predispute agreements is allowed by the Federal Arbitration Act but prohibited by the federal securities acts in the case of federal securities claims, and because it is critical to determine whether all claims arising from a single investor-broker dispute will be resolved by one tribunal, problems are created that are difficult to resolve rationally. This Article will examine some of these problems and offer suggestions for their resolution.

BACKGROUND LAW

The Federal Arbitration Act,²² which creates federal substantive law under the authority of the interstate commerce clause,²³ is central to evaluating the validity of predispute arbitration agreements. Section 2 of the Federal Arbitration Act provides that a predispute arbitration agreement in a contract evidencing a transaction involving commerce is valid.²⁴ Although an arbitration clause may provide that it shall be governed by state law, it is settled that federal law under the Federal Arbitration Act, not state law, controls.²⁵

20. In the Third, Eighth, and Ninth Circuits, where the controlling person standard is the measure of vicarious liability for a broker-dealer under federal securities law claims, when state claims initially are joined with federal claims but later severed for arbitration, the broker-dealer's liability in federal court will be strictly measured by the narrower controlling person standard. See note 19 *supra*.

21. Such a resolution was the express hope of the court in *Sibley v. Tandy Corp.*, 543 F.2d at 543-44. See text accompanying notes 132-137 *infra*.

22. 9 U.S.C. §§ 1-14 (1976).

23. See *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, 271 F.2d 402, 404-09 (2d Cir. 1959), *dismissed by stipulation*, 364 U.S. 801 (1960); *Romnes v. Bache & Co.*, 439 F. Supp. 833, 838 (W.D. Wis. 1977).

24. The full text of section 2 of the Federal Arbitration Act reads as follows:

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, *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 (1976) (emphasis added).

25. *Georgia Power Co. v. Cimarron Coal Corp.*, 526 F.2d 101, 107 (6th Cir. 1975), *cert. denied*, 425 U.S. 952 (1976); *Metro Indus. Parking Corp. v. Terminal Constr. Co.*, 287 F.2d 382, 385 (2d Cir. 1961); *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, 271 F.2d at 409; *In re Ferrara*, 441 F. Supp. 778, 780 n.2 (S.D.N.Y. 1977); *Romnes v. Bache & Co.*, 439 F. Supp. at 838.

Arbitration is both favored by a strong congressional policy²⁶ and encouraged by the federal courts as an alternative means by which to resolve disputes.²⁷ Consistent with this policy, section 3 of the Federal Arbitration Act²⁸ limits the court's role in determining the scope of claims covered by an arbitration agreement to deciding whether the party seeking arbitration has made a claim governed by the agreement.²⁹ Courts liberally determine the scope of claims covered by an arbitration agreement,³⁰ resolving all

26. See H.R. REP. NO. 96, 68th Cong., 1st Sess. 1-2 (1924). To ensure the effectiveness of arbitration, the Federal Arbitration Act also confers on courts the power to appoint an arbitrator when the arbitration clause is silent on this matter or when a vacancy occurs on a panel of previously designated arbitrators. 9 U.S.C. § 3 (1976). See *Astra Footwear Indus. v. Harwyn Int'l*, 442 F. Supp. 907 (S.D.N.Y. 1978). Courts are also empowered to vacate the arbitrator's award when the arbitrator was partial or when the award was procured through fraud, corruption, or other "undue means." 9 U.S.C. § 10 (1976). See *Commonwealth Corp. v. Casualty Co.*, 393 U.S. 145, 149 (1968) (holding that § 10 of the Federal Arbitration Act requires arbitrators to disclose to the parties any interests they have that might "create an impression of possible bias"). The refusal of an arbitrator to disqualify himself or herself ordinarily will be reviewable only after an award has been made. *Sanko S.S. Co. v. Cook Indus., Inc.*, 495 F.2d 1260, 1264 (2d Cir. 1973); *Catz Am. Co. v. Pearl Grange Fruit Exch.*, 292 F. Supp. 549, 551 (S.D.N.Y. 1968); *San Carlo Co. v. Conley*, 72 F. Supp. 825, 833 (S.D.N.Y. 1946), *aff'd*, 163 F.2d 310 (2d Cir. 1947). *But see Erving v. Virginia Squires Basketball Club*, 468 F.2d 1064, 1067 (2d Cir. 1972) (rejecting the argument that a court cannot substitute a neutral arbitrator as an attempt "to emasculate arbitration procedures under the federal act"). Finally, although the arbitration situs is usually found in the agreement itself, *Sam Reisfeld & Son Import Co. v. S. A. Eteco*, 530 F.2d 679, 680 (5th Cir. 1976), when a provision in an arbitration clause is unconscionable or puts a party at a great disadvantage, the court should modify it. See *Richards v. Merrill Lynch, Pierce, Fenner & Smith*, 64 Cal. App. 3d 899, 135 Cal. Rptr. 26 (1976).

27. *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 510-11 (1974). The courts of appeals have uniformly expressed approval of arbitration as a mode of private dispute resolution. See, e.g., *Stateside Mach. Co. v. Alperin*, 591 F.2d 234, 240 (3d Cir. 1979); *Hanes Corp. v. Millard*, 531 F.2d 585, 597 (D.C. Cir. 1976); *Southwest Indus. Import & Export, Inc. v. Wilmod Co.*, 524 F.2d 468, 470 (5th Cir. 1975); *DeCosta v. Columbia Broadcasting Sys., Inc.*, 520 F.2d 499, 505 (1st Cir. 1975), *cert. denied*, 423 U.S. 1073 (1976); *National R.R. Passenger Corp. v. Missouri Pacific R.R.*, 501 F.2d 423, 427 (8th Cir. 1974); *Aerojet General Corp. v. American Arb. Ass'n*, 478 F.2d 248, 251 (9th Cir. 1973); *Kulukundis Shipping Co. v. Amtorg Trading Co.*, 126 F.2d 978, 985 (2d Cir. 1942).

28. 9 U.S.C. § 3 (1976). Section 3 provides that the court shall stay its proceedings and refer a dispute to arbitration upon determining that the issue raised by the suit is one that the arbitration clause covers.

29. *Wick v. Atlantic Marine, Inc.*, 605 F.2d 166, 168 (5th Cir. 1979); *Bristol Farmers Market & Auction Co. v. Arlen Realty & Dev. Corp.*, 589 F.2d 1214, 1217-18 (3d Cir. 1978); *National R.R. Passenger Corp. v. Chesapeake & Ohio Ry.*, 551 F.2d 136, 140 (7th Cir. 1977); *Reconstruction Fin. Corp. v. Harrisons & Crosfield Ltd.*, 204 F.2d 366, 368 (2d Cir.), *cert. denied*, 346 U.S. 854 (1953).

30. See, e.g., *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, 271 F.2d at 411 (arbitration clause covering a "complaint, controversy or question which may arise with respect to this contract" was held to include a charge of fraud in the inducement); *Janmort Leasing, Inc. v. Econo-Can Int'l, Inc.*, 475 F. Supp. 1282, 1291-92 (E.D.N.Y. 1979) (clause requiring arbitration of "any controversy or claim arising out of or relating to" the contract held to include claims of breach of fiduciary duty, breach of contract, tortious interference with contractual relationships, fraud in the inducement, conversion, common law unconscionability, and unjust enrichment, but not usury or restraint of trade); *Local 1416, Int'l Ass'n of Machinists v. Jostens, Inc.*, 250 F.

doubts in favor of arbitration.³¹ Indeed, a particular dispute will be arbitrable unless the arbitration agreement cannot be rationally interpreted to cover it.³² Thus, the tendency of the courts is to find that practically any dispute arising out of the parties' contractual relationship is within the scope of the arbitration clause, and courts will find a dispute to be within the arbitration provision's scope unless it is clearly not.³³

An important question raised by the Act is whether any legal or equitable grounds will ever exist for revoking an arbitration clause.³⁴ Such grounds

Supp. 496, 500-01 (D. Minn. 1966) (arbitration clause covering problems of a collective bargaining agreement's "interpretation" related to the scope of managerial decision-making). *But see* Kulukundis Shipping Co. v. Amtorg Trading Corp., 126 F.2d at 985-86 (arbitration clause purporting to cover "a dispute of any nature whatsoever" does not extend to the issue of whether the parties ever had a meeting of the minds on the principal contract).

31. *See* cases cited in note 27 *supra*. In *Galt v. Libby-Owens-Ford Glass Co.*, 376 F.2d 711 (7th Cir. 1967), the court stated that the Federal Arbitration Act's policy is "to promote arbitration to accord with the intention of the parties and to ease court congestion. All doubts are to be resolved in favor of arbitration. . . . Whenever possible, the courts will use the Federal Arbitration Act to enforce agreements to arbitrate." *Id.* at 714 (citation omitted).

32. *Rockdale Village, Inc. v. Public Serv. Employees Union No. 80*, 605 F.2d 1290, 1295 (2d Cir. 1979); *Wick v. Atlantic Marine, Inc.*, 605 F.2d at 168; *Bristol Farmers Market & Auction Co. v. Arlen Realty & Dev. Corp.*, 589 F.2d at 1219; *National R.R. Passenger Corp. v. Chesapeake & Ohio Ry.*, 551 F.2d at 140; *United Eng'r & Foundry Employees Ass'n v. United Eng'r & Foundry Co.*, 389 F.2d 479, 481-82 (3d Cir. 1967). Although the Supreme Court, in *United Steelworkers v. Warrior & Gulf Navigation Co.*, 363 U.S. 574 (1960), distinguished the question of arbitration in the labor context from that in the commercial setting, *id.* at 578, the lower courts have grafted labor law arbitration decisions onto commercial litigation cases. *See, e.g., Georgia Power Co. v. Cimarron Coal Corp.*, 526 F.2d at 106.

33. For example, in *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967), the Supreme Court held that fraud in the inducement of a contract was encompassed by language calling for arbitration of a "claim arising out of or relating to" the contract. *Id.* at 398. Another court ruled that theft of business ideas, trade disparagement, and defamation were covered by a similar arbitration clause in an agreement among New York Stock Exchange members. *Legg, Mason & Co. v. Mackall & Coe, Inc.*, 351 F. Supp. 1367, 1371-72 (D.D.C. 1972).

In securities cases, state claims have been held to be within the scope of arbitration agreements. *E.g., Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831, 836 (7th Cir. 1977) (common law fraud, among others); *Sibley v. Tandy Corp.*, 543 F.2d at 544 (breach of contract); *DeHart v. Moore*, 424 F. Supp. 55, 56 (S.D. Fla. 1976) (breach of fiduciary duty); *Stockwell v. Reynold & Co.*, 252 F. Supp. 215, 220 (S.D.N.Y. 1965) (negligence). It is likely that the intentional infliction of emotional distress, conversion, and other torts arising out of the contractual relationship are claims also referable to arbitration under the standard broker-dealer arbitration agreement.

34. 9 U.S.C. § 2 (1976). Included in this issue is whether a party seeking to enforce an arbitration agreement is in default in proceeding with such agreement. *Id.* § 3. Some older decisions found "default," or waiver, simply when the party seeking arbitration did some act inconsistent with the claim that the dispute should be arbitrated. *See E.I. DuPont de Nemours & Co. v. Lyles & Lang Constr. Co.*, 219 F.2d 328, 334 (4th Cir. 1955) (filing of a counterclaim); *Galion Iron Works & Mfg. Co. v. J.D. Adams Mfg. Co.*, 128 F.2d 411, 413 (7th Cir. 1942) (filing of an action at law); *Cavac Campania Anonima Venezolana de Administracion y Comercio v. Board for Validation of German Bonds*, 189 F. Supp. 205, 209 (S.D.N.Y. 1960) (filing of an answer). The modern test for determining default is whether the opposing party has been prejudiced. *Shinto Shipping Co. v. Fibrex & Shipping Co.*, 572 F.2d 1328, 1330 (9th Cir. 1978); *Gaulik Constr. Co. v. H.F. Campbell Co.*, 526 F.2d 777, 783-84 (3d Cir. 1975); *Carolina*

clearly can exist because an agreement to arbitrate is simply a contract³⁵ that will not be enforced if valid reasons exist for its revocation or if the parties never consented to the agreement.³⁶ There must, however, be some nexus between the arbitration clause and a ground for revocation. For example, in *Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*,³⁷ the United States Supreme Court, presented with a claim of fraud in the inducement, distinguished whether the claimed invalidity went to the contract as a whole or just to its arbitration provision. The Court, interpreting the Federal Arbitration Act, held that when the fraud puts at issue the validity of the arbitration provision, the courts may decide the dispute.³⁸ If, however, the validity of the entire contract is in question, a court must stay its proceedings and submit the dispute to arbitration in accordance with the arbitration provision.³⁹

Although *Prima Paint* held that fraud must go to the arbitration clause itself before that clause will not be enforced, the case did not involve a situation in which a larger plan of fraud pervades the entire contract, including the arbitration provision. It is clear that an arbitration clause is also unenforceable when the agreement to arbitrate is part of a larger fraudulent

Throwing Co. v. S. & E. Novelty Corp., 442 F.2d 329, 331 (4th Cir. 1971); Hilti Inc. v. Oldach, 392 F.2d 368, 371 (1st Cir. 1968); Carcich v. Rederi A/B Nordi, 389 F.2d 692, 696 (2d Cir. 1968); American Broadcasting Cos. v. Ali, 434 F. Supp. 1108, 1112 (S.D.N.Y. 1977).

Prejudice has, however, rarely been shown. Indeed the only reported securities case in which default was found is *Liggett & Meyers, Inc. v. Bloomfield*, 380 F. Supp. 1044 (S.D.N.Y. 1974), in which the moving party obtained an answer and thousands of pages of testimony and documents during pretrial discovery before moving for arbitration. Prejudice is rare in the securities area primarily because federal securities claims are not arbitrable. See notes 46-66 and accompanying text *infra*. Instead of being dismissed, such claims are, at most, stayed pending arbitration of pendent claims. Discovery completed before the motion for arbitration will still be available in the trial of federal securities claims.

35. *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. at 404 n.12.

36. For example, if a signature on the arbitration agreement was forged, the contract is not enforceable and arbitration cannot be compelled. *Austin v. A.G. Edwards & Sons, Inc.*, 349 F. Supp. 615, 617 (M.D. Fla. 1972). But the lack of a signature is not controlling where other evidence shows that there was a meeting of the minds. *Tepper Realty Co. v. Mosaic Tile Co.*, 259 F. Supp. 688, 691 (S.D.N.Y. 1966). See generally *International Union of Operating Eng'rs Local 139 v. Carl A. Morse, Inc.*, 529 F.2d 574, 577-78 (7th Cir. 1976); *Georgia Power Co. v. Cimarron Coal Corp.*, 526 F.2d at 106; *Local 103, Int'l Union of Elec. Workers v. RCA Corp.*, 516 F.2d 1336, 1339 (3d Cir. 1975); *Blake Constr. Co. v. Laborers' Int'l Union*, 511 F.2d 324, 327 (D.C. Cir. 1975).

37. 388 U.S. 395 (1967).

38. *Id.* at 402-04. Section 4 of the Federal Arbitration Act provides that the court will compel arbitration when a party has failed to proceed to arbitration if "the making of the agreement for arbitration . . . is not in issue." 9 U.S.C. § 4 (1976). The Court in *Prima Paint* grafted this § 4 test onto § 2, stating that "it is inconceivable that Congress intended the rule to differ depending upon which party to the arbitration agreement first invokes the assistance of federal court." 388 U.S. at 404.

39. 388 U.S. at 403-04. In the following cases, the courts have not voided arbitration agreements when presented with general fraud allegations: *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831 (7th Cir. 1977); *Sibley v. Tandy Corp.*, 543 F.2d 540 (5th Cir. 1977); *Macchiavelli v.*

scheme. In *Moseley v. Electronic & Missile Facilities, Inc.*,⁴⁰ the petitioner argued that contracts it entered into in Georgia were fraudulently designed to force it to accept less than full value for its services and that a clause requiring arbitration of disputes in New York was one means used to perpetrate the fraud.⁴¹ The United States Supreme Court held that if fraud were proven, there was a sufficient connection between the fraud and the arbitration clause to find that clause unenforceable.⁴² Similarly, an illegal contract containing an arbitration clause closely related to the illegality will not be referred to arbitration.⁴³ Moreover, a breach of fiduciary duty may also render the arbitration agreement unenforceable.⁴⁴ Thus, while *Prima Paint* held that fraud must go to the arbitration clause itself, *Moseley* indicated that an arbitration clause should fail with the rest of the contract when a grand scheme of fraud permeates the entire contract.⁴⁵

THE WILKO v. SWAN DOCTRINE

Application to Action Based upon the Federal Securities Acts

Despite the general encouragement of arbitration under the Federal Arbitration Act,⁴⁶ in *Wilko v. Swan*⁴⁷ the Supreme Court erected an absolute bar to predispute agreements that would compel arbitration of federal securities law claims. In *Wilko*, a customer sued his brokerage firm for damages

Shearson, Hammill & Co., 384 F. Supp. 21 (E.D. Cal. 1974); *Stockwell v. Reynolds & Co.*, 252 F. Supp. 215 (S.D.N.Y. 1965).

40. 374 U.S. 167 (1963). The Court, in *Prima Paint*, implicitly upheld *Moseley*. 388 U.S. at 404 n.12.

41. 374 U.S. at 170-71.

42. *Id.* at 171.

43. See *Comprehensive Merchant Catalogs, Inc. v. Madison Sales Corp.*, 521 F.2d 1210, 1213 (7th Cir. 1975); *In re Weinrott*, 32 N.Y.2d 190, 197, 298 N.E.2d 42, 46, 344 N.Y.S.2d 848, 855 (1973); *Housekeeper v. Lourie*, 39 A.D. 2d 280, 284, 333 N.Y.S.2d 932, 937-38 (1972).

44. See *Chattanooga Mailers Local 92 v. Chattanooga News-Free Press Co.*, 524 F.2d 1305, 1313 (6th Cir. 1975); *Dickstein v. DuPont*, 443 F.2d 783, 786 (1st Cir. 1971).

45. In *Main v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 67 Cal. App. 3d 19, 136 Cal. Rptr. 378 (1977), defendant, a brokerage firm engaged in a confidential relationship of trust with plaintiff, an aged and unschooled customer, placed a lending agreement containing an arbitration clause before her for signature. Knowing that the plaintiff was completely unaware of all aspects of the document, defendant misrepresented its nature and content to plaintiff and did not advise her of the arbitration clause. In applying California contract law, the appellate court held that the defendant, a fiduciary, obtained an unfair advantage over plaintiff in securing the arbitration clause. *Id.* at 31; 136 Cal. Rptr. at 385.

The *Main* holding rested on the conclusion that the arbitration clause was biased against plaintiff. Courts have the authority to void unfair arbitration provisions without voiding the agreement to arbitrate altogether. See note 26 *supra*. Absent unfair terms controlling the arbitration procedure, it is doubtful that the arbitration agreement by itself is a material fact that a fiduciary must disclose. Unconscionable terms in an arbitration agreement also should not be a basis for denying arbitration altogether so long as the court can devise fair arbitration procedures.

46. See notes 3-6, 26-27, and accompanying text *supra*.

47. 346 U.S. 427 (1953).

under section 12(2) of the Securities Act for misrepresentations and omissions of information concerning the sale of stock.⁴⁸ The defendant brokerage firm moved to compel arbitration in accordance with the arbitration provision in the customer's margin agreement.⁴⁹ At issue was the effect of section 14 of the Securities Act, which provides that any provision, stipulation, or condition binding a person acquiring a security to waive compliance with any provision of the Securities Act is void.⁵⁰ The question before the Court was, therefore, whether the right to bring suit under the Securities Act is such a provision that cannot be waived.

To effectuate the Securities Act's express policy of protecting investors by requiring issuers and broker-dealers to provide full and fair disclosure of the character of securities,⁵¹ the Court concluded that section 12(2) was created to furnish investors with a "special right" more protective than rights at common law and held that trial could not be waived.⁵² The Court reasoned that a special right existed because a broker-dealer must assume the burden of proving lack of scienter under section 12(2),⁵³ and because under the Securities Act suit may be brought in federal court, where the investor has a wide choice of venue and nation-wide service of process.⁵⁴ The Court stated that these advantages are lost when the investor enters into a predispute arbitration agreement.⁵⁵ Furthermore, the Court

48. Section 12(2) of the Securities Act provides that any person who sells a security, . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or of oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him

15 U.S.C. § 771(2) (1952) (amended in 1954 to include the words "offers or" before the word "sells").

49. The arbitration clause provided:

Any controversy arising between us under this contract shall be determined by arbitration pursuant to the Arbitration Law of the State of New York, and under the rules of either the Arbitration Committee of the Chamber of Commerce of the State of New York, or of the American Arbitration Association, or of the Arbitration Committee of the New York Stock Exchange or such other Exchange as may have jurisdiction over the matter in dispute, as I may elect. Any arbitration hereunder shall be before at least three arbitrators.

346 U.S. 432 n.15.

50. 15 U.S.C. § 77n (1952).

51. Securities Act of 1933, Pub. L. No. 73-22, Preamble, 48 Stat. 74 (1933); S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933).

52. 346 U.S. at 430-31.

53. *Id.* at 431.

54. *Id.*

55. *Id.* at 435. Further disadvantages to arbitration found by the Court included the facts that arbitrators are without judicial instruction on the law, arbitrators may make judgments

suggested that at the time such agreements are made the investor may be unable "to judge the weight of the handicap the Securities Act places upon his adversary."⁵⁶ For these reasons, the *Wilko* Court concluded that Congress must have intended section 14 to apply to waivers of judicial trial.⁵⁷ Accordingly, it held that the predispute agreement to arbitrate claims arising under the Securities Act was effectively a waiver of provisions of the Securities Act and was, therefore, void.⁵⁸

without explaining their reasoning or providing a complete record of the proceedings, and the judicial power to vacate an arbitrator's award is limited. *Id.* at 435-37.

56. *Id.* at 435.

57. *Id.* at 437.

58. 346 U.S. at 438.

Courts have fashioned one exception, and suggested another, to the rule that predispute arbitration agreements are void.

The first exception to *Wilko* allows members of national securities exchanges to enter into valid arbitration agreements. The leading case, *Brown v. Gilligan, Will & Co.*, 287 F. Supp. 766 (S.D.N.Y. 1968), explained its conclusion that such agreements are binding between exchange members, stating, *inter alia*, that the Securities Act was not meant to protect "dealers from the improprieties of fellow dealers It was assumed that dealers could fend for themselves; it was the investing public that was in need of protection." *Id.* at 772.

The rule of *Brown* has been applied to various similar fact situations. *See, e.g.*, *Muh v. Newberger, Loeb & Co.*, 540 F.2d 970, 973 (9th Cir. 1976) (former New York Stock Exchange members required to arbitrate dispute in accordance with exchange rules); *Coenen v. R.W. Pressprich & Co.*, 453 F.2d 1209, 1213-14 (2d Cir.) (exchange members compelled to arbitrate securities dispute where claim arose before one party became a member), *cert. denied*, 406 U.S. 949 (1972); *Axelrod & Co. v. Kordick, Victor & Neufeld*, 451 F.2d 838, 841-43 (2d Cir. 1971) (non-member firm can compel member firm to arbitrate securities controversy). The rule has even been extended to enforce arbitration agreements between exchange members and their employees. *See, e.g.*, *Katz v. Shearson Hayden Stone, Inc.*, 438 F. Supp. 637, 637-42 (S.D.N.Y. 1977) (securities claim of former employee of member firm against firm stayed so that arbitration might be sought in accordance with agreement to arbitrate under stock exchange rules).

A number of courts have suggested a second exception, which holds that when knowledgeable parties deal at arms length, there is no reason to deny enforcement of a predispute arbitration agreement. *Alco Standard Corp. v. Benalal*, 345 F. Supp. 14, 24 (E.D. Pa. 1972) (*Wilko* rule did not apply where two sophisticated parties entered into securities arbitration agreement after arms length bargaining, and party seeking to avoid the provision was its author); *GCA Corp. v. Coler*, [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,339, at 91,815 (S.D.N.Y. 1972) (arbitration agreement is valid when entered into by parties dealing at arms length and from equal bargaining positions, because public interest is not at stake).

Some courts, however, have declined to apply the "sophisticated investor" exception. In *Miller v. Schweickart*, 405 F. Supp. 366 (S.D.N.Y. 1975), limited partners of a brokerage firm sought to avoid an arbitration provision contained in the partnership agreement when they sued the firm and the general partners, charging federal securities law violations. The court, having characterized the limited partners as investors with no voice in firm management, denied arbitration. The court stated that although some limited partners may be sophisticated, many are not, and held that courts should not be required in every case to rule on the sophistication of the parties. Rather, the court concluded that an objective test is more appropriate, and held that limited partners are protected by the federal securities acts to the same extent as is the general investing public. *Id.* at 369. *See Newman v. Shearson, Hammill & Co.*, 383 F. Supp. 265 (W.D. Tex. 1974) (federal securities laws do not distinguish between sophisticated and unsophisticated investors).

Although the Court's decision in *Wilko* concerned the arbitrability of claims brought only under section 12(2) of the Securities Act, courts have subsequently held that claims of violations of sections 5⁵⁹ and 17⁶⁰ of the Securities Act are non-arbitrable. In addition, section 29(a) of the Exchange Act contains a provision similar to that in section 14 of the Securities Act.⁶¹ By analogy to *Wilko*, it is generally accepted that section 29(a) renders void arbitration agreements for claims based on the Exchange Act,⁶² and predispute arbitration agreements have been held void with respect to sections 7,⁶³ 10(b),⁶⁴ and 15(c)(1)⁶⁵ of that Act. Similarly, agreements to arbitrate claimed violations of various stock exchange rules have been held void.⁶⁶ It is doubtful, therefore, that a court will hold arbitrable any of the causes of action arising out of either the Securities Act or the Exchange Act.

The Supreme Court, in *Scherk v. Alberto-Culver*,⁶⁷ however, advanced the argument that *Wilko* does not apply to private claims not expressly established by the Exchange Act.⁶⁸ The *Scherk* Court stated that *Wilko* concerned a suit brought under a section of the Securities Act that expressly "provides a defrauded purchaser with the 'special right' of a remedy for civil

59. For violations of § 5, 15 U.S.C. § 77e (1976) (registration requirements), see *Laupheimer v. McDonnell & Co.*, 500 F.2d 21 (2d Cir. 1974); *Maheu v. Reynolds & Co.*, 282 F. Supp. 423 (S.D.N.Y. 1968).

60. For violations of § 17, 15 U.S.C. § 77q (1976) (prohibition of fraud in interstate transactions), see *Davend Corp. v. Michael*, [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,540 (S.D.N.Y. 1976); *Frier Indus. Inc. v. Glickman*, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,845 (S.D.N.Y. 1974); *Cohen v. Franchard Corp.*, [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 92,810 (S.D.N.Y. 1970).

61. Securities and Exchange Act of 1934 § 29(a), 15 U.S.C. § 78cc(a) (1976), provides: "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void."

62. See cases cited in notes 63-65 *infra*.

63. For violations of § 7, 15 U.S.C. § 78g (1976) (margin requirement violations), see *Reader v. Hirsch & Co.*, 197 F. Supp. 111 (S.D.N.Y. 1961).

64. For violations of § 10(b) and rule 10b-5, 15 U.S.C. § 78j(b) (1976) and rule 10b-5, 17 C.F.R. 240.10b-5 (1979) (anti-fraud provisions), see *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831 (7th Cir. 1977); *Sibley v. Tandy Corp.*, 543 F.2d 540 (5th Cir. 1976), *cert. denied*, 434 U.S. 824 (1977); *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532 (3d Cir.), *cert. denied*, 429 U.S. 1010 (1976).

65. For violations of § 15(c)(1), 15 U.S.C. § 78o(c)(1) (1976) (prohibition of use of manipulative devices), see *Laupheimer v. McDonnell & Co.*, 500 F.2d 21 (2d Cir. 1974).

66. See *Laupheimer v. McDonnell & Co.*, 500 F.2d 21 (2d Cir. 1974) (New York Stock Exchange Rule 325); *Starkman v. Seroussi*, 377 F. Supp. 518 (S.D.N.Y. 1974) (New York Stock Exchange Rules 345.17, 345.19, and 405). The New York Stock Exchange Rules were adopted by the exchange as a prerequisite to its registration pursuant to sections 6(d) and 19 of the Exchange Act, 15 U.S.C. §§ 78f(d), 78s (1976). A split of authority exists as to whether a private right of action lies for violations of these rules. Compare *Starkman*, *supra*, (private right for violation of some exchange rules implied by § 27 of the Exchange Act, 15 U.S.C. § 78aa (1976)) with *Nelson v. Hench*, 428 F. Supp. 411 (D. Minn. 1977) (private right not implied by § 27 because Congress did not contemplate causes of action arising under exchange rules).

67. 417 U.S. 506 (1974).

68. *Id.* at 513-14.

liability," and that no statutory counterpart to section 12(2) exists in the Exchange Act.⁶⁹ The Court reasoned that although case law has established that section 10(b) and rule 10b-5 create an implied private right of action, this right is not "special" because it was not legislatively formulated.⁷⁰ Stating that the *Wilko* decision had established the significance of a "special right," the *Scherk* Court suggested, but did not decide, that agreements to arbitrate disputes arising out of implied rights under federal securities law may be valid.⁷¹

Nevertheless, lower courts have rejected the *Scherk* suggestion, regarding as not dispositive the fact that the right was legislatively created.⁷² The Third Circuit has explicitly stated that neither the differences between the rights granted in the Securities Act or the Exchange Act nor any consideration of policy warrant such a distinction,⁷³ the Seventh Circuit has asserted that policy considerations mandate the application of *Wilko* to rule 10b-5 situations,⁷⁴ and the SEC has recently stated that *Wilko* applies to arbitration agreements for implied rights of action arising under the Exchange Act.⁷⁵

A Comparison—The Arbitration of Antitrust Law Claims

The *Wilko* rationale for not enforcing predispute arbitration agreements for federal securities claims differs from the reasons given for the invalidity of such agreements under antitrust law. For antitrust claims, courts have referred to the broad range of public interest affected by private antitrust actions.⁷⁶ They have determined that a claim arising under antitrust law is not merely a private matter because private antitrust actions are an integral part of the design of the antitrust laws to promote the national interest in a competitive economy.⁷⁷ Accordingly, courts have reasoned that it is doubt-

69. *Id.* at 513, quoting *Wilko v. Swan*, 346 U.S. at 431.

70. *Id.* (citations omitted). A private right of action has been implied for claims under § 10(b) and SEC rule 10b-5. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 & n.9 (1971).

71. 417 U.S. at 513.

72. *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d at 835; *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d at 536-37.

73. *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d at 536.

74. *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d at 835.

75. Securities Exchange Act Release No. 15984, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,122. The SEC criticized the use of arbitration agreements that purport to bind customers to arbitrate all future disputes with a broker-dealer. *Id.* at 81,976-78. It reasoned that because the language of arbitration agreements does not reflect the limited enforceability of arbitration provisions, many investors may be unaware of their right to a judicial forum for the pursuit of claims arising under the federal securities laws. *Id.* at 81,975. As a result, the SEC felt that it was incumbent upon those who include arbitration clauses in agreements with customers to provide adequate information about such rights in order to make the clauses not misleading. *Id.*

76. See cases cited in note 77 *infra*.

77. *Applied Digital Tech., Inc. v. Continental Cas. Co.*, 576 F.2d 116, 117 (7th Cir. 1978); *Cobb v. Lewis*, 488 F.2d 41, 47 (5th Cir. 1974); *Power Replacements, Inc. v. Air Preheater*

ful that Congress could have intended such claims to be resolved in a non-judicial forum.⁷⁸ Another reason given for nonenforceability of predispute arbitration agreements in antitrust cases is that the courts feel far better suited than arbitrators to resolve the complex legal and factual issues and extensive evidentiary questions.⁷⁹ Finally, because antitrust laws regulate the business community,⁸⁰ courts question the propriety of entrusting the decision of antitrust issues to commercial arbitrators who are frequently chosen for their business expertise.⁸¹

The *Wilko* opinion, focusing only on the individual investor's forfeiture of rights provided under federal securities law, did not discuss whether the broad policy considerations referred to in the antitrust actions are relevant to securities cases. Assuming that fair arbitration procedures protective of rights given by the Securities Act can be implemented,⁸² the question arises whether the policy considerations and public interests evident in antitrust cases would still preclude enforcement of arbitration agreements in the securities field.

The answer to this query is unclear. In *Allegaert v. Perot*,⁸³ the Second Circuit considered the antitrust policy grounds and denied arbitration in an action involving securities issues. The policy issues were considered because the case involved "no mere dispute between private parties,"⁸⁴ but rather a

Co., 426 F.2d 980, 983-84 (9th Cir. 1970); *American Safety Equip. Corp. v. J. P. Maguire & Co.*, 391 F.2d 821, 826-27 (2d Cir. 1968).

Courts have also held that patent law claims are not arbitrable under a predispute arbitration agreement. Essentially the same reason has been given—the public interest in questions of patent validity and infringement renders such issues inappropriate for arbitration. See *Beckman Instruments, Inc. v. Technical Dev. Corp.*, 433 F.2d 55, 62-63 (7th Cir. 1970); *Foster Wheeler Corp. v. Babcock & Wilcox Co.*, 440 F. Supp. 897, 901 (S.D.N.Y. 1977); *Diematic Mfg. Corp. v. Packaging Indus., Inc.*, 381 F. Supp. 1057, 1061 (S.D.N.Y. 1974), *appeal dismissed*, 516 F.2d 975 (2d Cir.), *cert. denied*, 423 U.S. 913 (1975); *Leesona Corp. v. Cotwool Mfg. Corp.*, 204 F. Supp. 141, 143 (W.D.S.C. 1962), *aff'd*, 315 F.2d 538 (4th Cir. 1963).

78. *Applied Digital Tech., Inc. v. Continental Cas. Co.*, 576 F.2d at 117; *Cobb v. Lewis*, 488 F.2d at 47; *American Safety Equip. Co. v. J.P. Maguire & Co.*, 391 F.2d at 826-27.

79. See cases cited in note 77 *supra*.

80. See § 1 of the Sherman Act, 15 U.S.C. § 1 (1976) and § 1 of the Clayton Act, 15 U.S.C. § 12 (1976), which define the subject of their regulation as "trade or commerce." "Trade or commerce" has been defined by the Supreme Court to include "any occupation, employment or business . . . carried on for the purpose of profit, or gain . . ." *United States v. National Ass'n of Real Estate Bds.*, 339 U.S. 485, 490-91 (1950) (emphasis added).

81. See cases cited in note 77 *supra*.

82. See notes 155-164 and accompanying text *supra*.

83. 548 F.2d 432 (2d Cir.), *cert. denied*, 432 U.S. 910 (1977).

84. *Id.* at 436. In *Allegaert*, the trustee in bankruptcy of du Pont Walston, Inc., brought suit against, *inter alia*, Perot, Electronic Data Systems Corporation, du Pont Glore Forgan, Inc., the New York Stock Exchange, and several directors of du Pont Walston, Inc., alleging violations of the Securities Act, the Exchange Act, the Bankruptcy Act, state corporation law and the common law. *Id.* at 434. The claims arose out of a complex scheme to defraud du Pont Walston, Inc.

Perot was the controlling stockholder of Electronic Data Systems Corporation. *Id.* at 433. He invested large sums of money in and took control of du Pont Glore Forgan, Inc., a brokerage

claim asserted on behalf of hundreds of creditors in connection with a celebrated brokerage house failure. The court stated that the case, like antitrust cases, raised broad policy questions more adequately handled by the federal courts than by arbitrators.⁸⁵

Allegaert is, however, an exception; it is questionable whether a single investor-broker dispute involves policy concerns similar to those raised in *Allegaert*. The second policy—disinclination to allow arbitration in the presence of complex legal and factual issues more appropriate for judicial resolution—is inapplicable because the vast majority of investor disputes involve rule 10b-5 violations,⁸⁶ which present legal issues no more complex than common law fraud⁸⁷ and are not typically factually complex.⁸⁸ The third policy—distrust of commercial entrepreneurs to judge themselves in arbitration—is particularly inappropriate in securities law disputes because a fundamental design of the securities laws is the promotion of self-regulation

firm. Soon thereafter, when du Pont Glore Forgan, Inc., was on the brink of insolvency, Perot conceived a realignment plan whereby du Pont Walston, Inc., in which Perot was a minority stockholder, would assume immense du Pont Glore Forgan liabilities, thereby protecting it from future loss. *Id.* at 434. This plan was railroad through the du Pont Walston Board of Directors in a meeting at which misrepresentations were made. The New York Stock Exchange concealed its conclusion that the plan would render du Pont Walston insolvent in a short time, allegedly because of fear of the liability it would accrue if du Pont Glore Forgan, Inc., were liquidated. *Id.* The defendants contended that the suit should be stayed pending arbitration as provided for by the constitutions of the New York Stock Exchange and the American Stock Exchange, and the realignment agreement. *Id.* at 434-35.

85. *Id.* at 437.

86. 5 A. JACOBS, *THE IMPACT OF RULE 10b-5 § 1 & Foreword* at ix (rev. ed. 1979) [hereinafter cited as JACOBS]; E. BRODSKY, *GUIDE TO SECURITIES LITIGATION* 75 (1974).

87. The elements of a cause of action in fraud at common law are, generally: a false representation of fact known to be untrue by the party making it; intent of that party to deceive and to induce the other party to act on the misrepresentation; justifiable reliance by the other party; and damage to that party as a result of his or her reliance. W. PROSSER, *LAW OF TORTS* 685-86 (4th ed. 1971). The elements of a rule 10b-5 action are less clear. Indeed, one commentator has stated "[t]hat the ingredients of a 10b-5 cause of action have not been determined with a degree of accuracy . . . would be considered an understatement by many." JACOBS, *supra* note 86, § 36, at 2-2 to 2-3. Nevertheless, it appears that the elements of a 10b-5 claim include misrepresentation of a material fact, privity, scienter, reliance and damages. 3A H. BLOOMENTHAL, *SECURITIES AND FEDERAL CORPORATE LAW* § 9.21-.22 (rev. ed. 1979). The requirement of proving certain of these elements has, however, been relaxed. JACOBS, *supra* note 86, § 36, at 2-6. In short, the legal issues involved in fraud and rule 10b-5 cases are similar.

88. *Wilko v. Swan*, 346 U.S. 427 (1953), presents a typical fact situation. Wilko claimed that he was induced to purchase 1,600 shares of stock of Air Associates, Inc., by a brokerage firm's false representations that Air Associates had merged with Borg Warner Corporation, thereby increasing the value of the stock and causing large financial interests to buy the stock. *Wilko v. Swan*, 107 F. Supp. 75, 76 (S.D.N.Y. 1952). It was also alleged that Page, a director, counsel, and stockholder of Air Associates, was at the same time selling his stock—some of which was purchased by Wilko. *Id.* The central issue of fact was whether these representations were prohibited by § 12(2) of the Securities Act of 1933, 15 U.S.C. § 77(2) (1976), as either untrue statements of material facts or a failure to state material facts necessary to make the statements not misleading. 107 F. Supp. at 76-77.

by the securities industry.⁸⁹ It is consistent with this policy to encourage the involvement of the industry in dispute resolution by arbitration.

Finally, the first policy—resolution of important issues in the public forum—also does not realistically apply to the simple investor-broker dispute. Where a business has engaged in conduct violative of the antitrust laws, literally thousands of people may be affected and great economic damage inflicted.⁹⁰ On the other hand, investor-broker disputes often impact no one but the parties involved.⁹¹ Because of the smaller number of persons who might be adversely affected by the outcome of most disputes, there is clearly a lesser interest in public resolution of investor-broker disputes. In these cases, any public interest in being informed may be outweighed by the advantages of arbitration.⁹² Even if public notice is deemed

89. See S. REP. NO. 792, 73d Cong., 2d Sess. 13 (1934); H. R. REP. NO. 1383, 73d Cong., 2d Sess. 15 (1934). See also *Silver v. New York Stock Exch.*, 373 U.S. 341, 349-57 (1962); W. DOUGLAS, *DEMOCRACY AND FINANCE* 82 (1940); E. WEISS, *REGISTRATION AND REGULATION OF BROKERS AND DEALERS* 231-32 (1965). See generally Cary, *Self-Regulation in the Securities Industry*, 49 A.B.A.J. 244 (1963); Jennings, *Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission*, 29 L. & CONTEMP. PROB. 661 (1964); Westwood & Howard, *Self-Government in the Securities Business*, 17 L. & CONTEMP. PROB. 518 (1952).

Long before the enactment of the Exchange Act, stock exchanges were regulating the admission and conduct of exchange members. Jennings, *Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission*, 29 L. & CONTEMP. PROB. 661, 664 (1964). As a result of economic changes, the growth of stock exchanges and their impact upon the economy, and 'the exchanges' inability to curb abuses through self-regulation, Congress enacted the Exchange Act. See S. REP. NO. 792, 73d Cong., 2d Sess. 2-5 (1934); H. R. REP. NO. 1383, 73d Cong., 2d Sess. 2-5 (1934). The beginning of governmental regulation did not, however, totally displace self-regulation. The intent of the legislature was to give the exchanges "the initiative and responsibility for promulgating regulations pertaining to the administration of their ordinary affairs . . ." S. REP. NO. 792, 73d Cong., 2d Sess. 13 (1934). Congress further stated that "[i]t is only where [the exchanges] fail adequately to provide protection to investors that the Commission is authorized to step in and compel them to do so." *Id.*

90. See, e.g., *Chattanooga Foundry & Pipe Works v. City of Atlanta*, 203 U.S. 390 (1906); *Atlantic City Elec. Co. v. General Elec. Co.*, 226 F. Supp. 59 (S.D.N.Y.), *appeal dismissed*, 337 F.2d 844 (2d Cir. 1964). In both *Chattanooga Foundry* and *Atlantic City*, public utilities brought suit for damages resulting from their purchase of overpriced materials sold in violation of federal antitrust law. The issue in each case was whether the overcharges, admittedly shifted by the utilities to their customers, must be deducted from the amount of damages otherwise collectible from the suppliers. Conceivably millions of people who paid excessive charges had an interest in the outcome of this antitrust litigation.

91. Many investor-broker disputes involve only a few persons. See, e.g., *Wilko v. Swan*, 346 U.S. at 429 (one plaintiff and two defendants); *Macchiavelli v. Shearson, Hammill & Co., Inc.*, 384 F. Supp. 21, 23 (E.D. Cal. 1974) (one plaintiff and one defendant); *Shapiro v. Jaslow*, 320 F. Supp. 598, 599 (S.D.N.Y. 1970) (two plaintiffs and two defendants). Yet other class actions involve thousands of parties. See, e.g., *Green v. Wolf Corp.*, 406 F.2d 291, 295 (2d Cir. 1968) (approximately 2,200 plaintiffs). For the large cases, such as *Green* and *Allegaert*, the first policy—resolution of issues in the public forum—may be present.

92. The primary advantage of arbitration is the relatively speedy and inexpensive disposition of disputes compared with judicial resolution. See, e.g., *Aerojet-General Corp. v. American Arb. Ass'n*, 478 F.2d 248, 251 (9th Cir. 1973); *Kulukundis Shipping Co. v. Amtorg Trading Co.*, 126 F.2d 978, 985 (2d Cir. 1942); *Madden v. Kaiser Foundation Hosps.*, 17 Cal. 3d 699, 707, 552 P.2d 1178, 1182, 131 Cal. Rptr. 882, 886 (1976). See notes 3-6, 22-23, and accompanying text *supra*.

important, notice could be satisfied simply by requiring all arbitrations to be reported to the SEC, rather than by rendering arbitration agreements absolutely ineffective.⁹³

ARBITRATION OF PENDENT STATE LAW CLAIMS

Because investor-broker accounts frequently involve both a contractual and a fiduciary relationship,⁹⁴ injured investors commonly assert—in addition to claims of common law fraud⁹⁵—state law claims for breach of contract, breach of fiduciary duty,⁹⁶ and damages for intentional infliction of emotional distress.⁹⁷ State law claims arising from securities dealings often are joined with federal securities law claims.⁹⁸ The primary reason for pleading state causes of action along with federal securities claims is to recover punitive damages, because although punitive damages are not recoverable under the federal securities acts, they may be recovered under pendent state claims.⁹⁹

93. The "public interest" exception to arbitration is further undercut by the number of securities actions that *are* arbitrable, such as disputes between members of securities exchanges and brokerage firms or between sophisticated investors. See cases cited in note 58 *infra*.

94. See, e.g., *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1026 (6th Cir. 1979); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 45 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978). It has been held, however, that where a sophisticated investor made all his investment decisions on his own, no fiduciary relationship existed between the investor and his broker. *Shearson Hayden Stone, Inc. v. Leach*, 583 F.2d 367, 371-72 (7th Cir. 1978).

95. See, e.g., *Mansbach v. Prescott, Ball & Turben*, 598 F. 2d at 1021; *DeHart v. Moore*, 424 F. Supp. 55, 56 (S.D. Fla. 1976); *Greitzer v. United States Nat'l Bank*, 326 F. Supp. 762, 762 (S.D. Cal. 1971).

96. See, e.g., *Mansbach v. Prescott, Ball & Turben*, 598 F.2d at 1021; *Shearson Hayden Stone, Inc. v. Leach*, 583 F.2d at 370-72; *Macchiavelli v. Shearson, Hammill & Co.*, 384 F. Supp. 21, 23 (E.D. Cal. 1974).

97. Cf. *Greitzer v. United States Nat'l Bank*, 326 F. Supp. at 764-65. In *Greitzer*, plaintiff sought damages for mental distress predicated upon claims involving the Securities Act, the Exchange Act, and common law deceit. 326 F. Supp. at 762-63. The court denied recovery for emotional distress under the Exchange Act because § 28(a) of the Act, 15 U.S.C. § 78bb(a) (1976), limits recovery to "actual damages", and under the Securities Act because the language of § 12, 15 U.S.C. § 771 (1976), strongly implies that recovery is allowable only for damages of a financial nature. 326 F. Supp. at 763-64. In denying recovery for emotional distress under the common law deceit claim, the *Greitzer* court concluded that no "outrageous conduct" had been alleged, and therefore no proper claim of intentional infliction of emotional distress had been pleaded under California law. *Id.* at 765.

98. See, e.g., *Mansbach v. Prescott, Ball & Turben*, 598 F. 2d at 1021-22 (contract, fiduciary duty and fraud with rule 10b-5); *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d at 41, 45 (fiduciary duty with rule 10b-5), *cert. denied*, 439 U.S. 1039 (1978); *Macchiavelli v. Shearson, Hammill & Co.*, 384 F. Supp. at 23 (contract with SEC Regulation T—promulgated pursuant to § 7 of the Exchange Act—and rule 10b-5); *Greitzer v. United States Nat'l Bank*, 326 F. Supp. at 762 (fraud and emotional distress with § 17(a) of the Securities Act and 10b-5); *Maheu v. Reynolds & Co.*, 282 F. Supp. 423, 424 (S.D.N.Y. 1967) (fiduciary duty with §§ 5, 12(2) and 17 of the Securities Act and rule 10b-5).

99. See note 18 and accompanying text *supra*. Another reason concerns the standard of liability in agency situations. See notes 19-20 and accompanying text *supra*.

The language of the securities acts is of no help in determining whether pendent state claims are arbitrable, and the Supreme Court has not addressed this question. Consequently, the federal courts have been left to formulate their own guidelines when nonarbitrable federal securities law claims are joined with causes of action under state law.

Arbitrable Pendent Claims

Where both arbitrable and nonarbitrable claims are present in a single action, the general presumption is that the court should sever the action so that all arbitrable claims are arbitrated and all nonarbitrable claims are litigated.¹⁰⁰ The rationale for severance was stated by one court to be the desire not to deprive the parties of either their contractual rights or their rights under the Federal Arbitration Act.¹⁰¹ While courts often do recognize that severance of substantially related claims may prolong disputes and result in duplication of effort, they will subordinate the goal of expediency to their duty to enforce an individual's basic right to contract, and the action will be severed. The general presumption in favor of severance, however, has had to yield in numerous cases to countervailing considerations that render severance impracticable or inappropriate.

Pendent claims of breach of contract and breach of fiduciary duty have been severed from securities claims and arbitrated in every case in which the issue of severance has been raised. For example, in *Macchiavelli v. Shearson, Hammill & Co.*,¹⁰² plaintiff brought suit against a broker-dealer with whom he maintained a margin account, alleging breach of contract, violation of regulation T,¹⁰³ and violation of rule 10b-5.¹⁰⁴ The breach of contract claim was based on defendant's purported refusal to allow plaintiff to withdraw funds from the account in excess of a 30% margin requirement set by the broker.¹⁰⁵ The allegation of violation of rule 10b-5 stemmed both

100. See e.g., *Sam Reinfeld & Son Import Co. v. S.A. Eteco*, 530 F.2d 679, 680 (5th Cir. 1976) (nonarbitrable antitrust claims severed from other arbitrable claims); *Council of Western Elec. Technical Employees—Nat'l v. Western Elec. Co.*, 238 F.2d 892, 896-97 (2d Cir. 1956) (where defendant in a labor dispute forfeited its right to arbitrate certain issues, but not others, the action was severed); *Macchiavelli v. Shearson, Hammill & Co.*, 384 F. Supp. at 30 (rule 10b-5 claim severed from arbitrable contract claim).

101. *Yunker Bros., Inc. v. Standard Constr. Co.*, 241 F. Supp. 17, 19 (S.D. Iowa 1965).

102. 384 F. Supp. 21 (E.D. Cal. 1974).

103. 12 C.F.R. § 220 (1979).

104. 384 F. Supp. at 23-24. In addition, there were allegations of violation of other federal securities rules and regulations that were not specified in plaintiff's complaint.

105. *Id.* at 23. Plaintiff had a margin account with defendant. A margin account is one in which an investor makes purchases of securities on credit. Under federal law, stock exchange rules, and agreements between investors and brokers, an investor buying on credit must initially pay a specified part of the purchase price of securities in cash in order to receive an extension of credit from the broker for the unpaid balance. The percentage of the purchase price the investor must pay is the "margin requirement." The federal margin requirements are set forth in Regulation T, 12 C.F.R. § 220 (1979). However, the stock exchanges are free to superimpose their own margin requirements upon those of the regulation. Regulation T § 7(e), 12 C.F.R. § 220.7 (e) (1979). In addition, a broker may set his or her own margin requirements

from the defendant's alleged employment of fraudulent and manipulative devices in notifying plaintiff of funds needed to meet a margin maintenance requirement,¹⁰⁶ and from defendant's submission of false and deceptive account status reports to another brokerage firm to prevent transfer of plaintiff's account.¹⁰⁷ The complaint did not specify the basis for the claimed violation of the regulation T margin rules.¹⁰⁸

Defendant moved to stay the court proceedings pending arbitration of plaintiff's claims pursuant to a predispute arbitration agreement contained in the investor-broker margin account agreement.¹⁰⁹ Although it recognized that the rule 10b-5 claim was nonarbitrable,¹¹⁰ the court held that both the claimed violation of regulation T and the contract claim were arbitrable.¹¹¹ The question became, therefore, whether the action should be severed, with the arbitrable claims arbitrated and the nonarbitrable claims tried, or whether the court should retain jurisdiction over the entire cause of action.¹¹² While recognizing that all the claims were related, the court held that the rule 10b-5 claim was "clearly severable from the other claims, both factually and legally,"¹¹³ reasoning that severance "would serve well the purposes of both the Securities and Exchange Act . . . and the Federal Arbitration Act."¹¹⁴

Upon closer inspection, the situation in *Macchiavelli* indicates that the arbitrable and nonarbitrable claims were not as distinct as the court thought.¹¹⁵ Certainly, the contract claim and the rule 10b-5 claim based on

when entering into a relationship with an investor, Regulation T §§ 7(b), (e), 12 C.F.R. §§ 220.7(b), (e) (1979), and, generally, brokers do require investors to maintain their cash contributions at a certain minimum percentage of the market value of stocks in the investor's account. *Macchiavelli v. Shearson, Hammill & Co.*, 384 F. Supp. at 29 n.1. This percentage is called the maintenance level. In *Macchiavelli*, the plaintiff was required to maintain a 30% maintenance level at all times, but he could withdraw excess funds over that amount. *Id.*

106. 384 F. Supp. at 24. When, as a result of a declining stock market, the investor's cash investment falls below the statutory, stock exchange, or contractually-agreed-upon maintenance level, the broker can call upon the investor for additional investment of cash. If the investor is unable to make additional contributions, the broker may liquidate a portion of the account to reestablish the maintenance level. It was alleged in *Macchiavelli* that defendant used fraudulent devices in notifying plaintiff of the maintenance level of plaintiff's account, consequently forcing unnecessary liquidations to plaintiff's detriment.

107. *Id.*

108. *Id.* at 30-31.

109. *Id.* at 24. The margin agreement read as follows: "[A]ny controversy arising out of or relating to my account, to transactions with you for me or to this agreement or the breach thereof shall be settled by arbitration." *Id.* at 25.

110. *Id.* at 27, citing *Wilko v. Swan*, 346 U.S. 427 (1953).

111. *Id.* at 30-31.

112. *Id.* at 31.

113. *Id.*

114. *Id.*

115. Certainly, there is some basis for the court's conclusion that the contract claim was severable from the rule 10b-5 claim in that to maintain an action for breach of contract, a plaintiff must plead and prove the existence of a contract, fulfillment of any conditions precedent to the defendant's duty to perform, and defendant's failure to perform. On the other hand,

defendant's use of manipulative devices in notifying plaintiff of the funds needed to meet margin requirements were not so "clearly severable." Although it is true that the legal elements needed to prove each claim differ, very similar facts must have been put into evidence to prove either claim. For example, the contract provided that "[plaintiff] will maintain such margins as [defendant] may in [defendant's] discretion require . . . , [defendant] may, . . . in [defendant's] discretion . . . sell any or all property held in any of [plaintiff's] accounts . . . without actual notice to [plaintiff]." ¹¹⁶ This language is also crucial to the rule 10b-5 claim predicated on defendant's use of manipulative devices in notifying plaintiff of maintenance requirements, because under this contract provision, it may be that no notification was necessary. Evidence of this contractual language would, therefore, be relevant in determining whether the defendant did, indeed, act in a fraudulent manner within the scope of rule 10b-5, as well as whether the defendant breached the contract. Thus, the court in *Macchiavelli* seems to have grossly overstated the factual and legal severability of the contract and rule 10b-5 claims.

Severability was also at issue in *DeHart v. Moore*, ¹¹⁷ in which plaintiff charged that defendants misrepresented the amount of commissions they were to receive by acting as plaintiff's agents. Defendants were charged with violating rule 10b-5, breach of contract, and breach of fiduciary duty. ¹¹⁸ Although the court recognized that the claims were based on substantially similar factual allegations, it held the pendent state law claims severable because the requisite mental state differed for the federal and state claims; ¹¹⁹ whereas negligence could support a claim for breach of fiduciary duty and no mental state need be shown for breach of contract, scienter is an element of an action under rule 10b-5. ¹²⁰

Other cases exist in which securities law and state law issues have been deemed too close factually or legally to permit severance; ¹²¹ however, severance seems to be the rule rather than the exception. ¹²² Although the

the elements of a rule 10b-5 action are misrepresentation of a material fact, privity, scienter, reliance, and damages. The factual foundations of either legal theory overlap, however, quite substantially.

116. 384 F. Supp. at 32.

117. 424 F. Supp. 55 (S.D. Fla. 1976).

118. *Id.* at 56-57.

119. *Id.* at 57.

120. *Id.*

121. *See, e.g.,* *Sibley v. Tandy Corp.*, 543 F.2d 540 (5th Cir. 1976), *cert. denied*, 434 U.S. 824 (1977). *Cf. Mansbach v. Prescott, Ball & Turben*, 598 F.2d at 1030-31.

122. *See, e.g.,* *Stockwell v. Reynolds & Co.*, 252 F. Supp. 215 (S.D.N.Y. 1965). In *Stockwell*, common law claims, including breach of fiduciary duty, were joined with federal securities law claims. The court noted:

[T]he relief sought in each of these [common law] counts is based on the same transactions which are the subject of the Securities Exchange Act counts, which must be determined by the court under the *Wilko* doctrine. There would appear to be little purpose in having both the court proceeding and the arbitration going on at the same time, and doubtless the ultimate determination by the court of [the se-

Macchiavelli and *DeHart* courts stated that there can be no severance unless the factual and legal issues are *clearly* severable, the apparent rule of these cases is that notwithstanding substantial overlap of issues, if the federal claim requires some additional fact-finding, the claim is severable. Thus, even though a majority of the issues are identical and duplicative, severance is justified if some difference in the claims can be identified.

Fraud—The Truly “Intertwined” Claim

The difficulty in finding some rationale to support severance of substantially overlapping claims is most pronounced in cases involving both rule 10b-5 violations and pendent state claims for common law fraud. In these situations no coherent theory to resolve conflicting policies has developed, and, as a result, courts disagree whether such intertwined claims are severable. Those courts permitting severance and arbitration of state law claims simply hold that the non-waiver provisions of section 14 of the Securities Act¹²³ and section 29(a) of the Exchange Act¹²⁴ bar arbitration only for those causes of action based on the federal securities laws.¹²⁵ Under this approach, “the non-waiver provisions of the federal securities laws . . . do not apply to pendent state claims, and . . . those claims are . . . subject to valid arbitration agreements.”¹²⁶

Other courts have, however, refused to grant arbitration of pendent state law fraud claims because those claims are based on, or “intertwined with,” the same factual allegations as the federal securities fraud claims. This line of authority has its genesis in *Shapiro v. Jaslow*,¹²⁷ in which it was alleged that defendants generally had failed to follow either the principles of the Securities Act, the Exchange Act, the SEC, the New York Stock Exchange, the

curities law claims] would have a definite bearing on the outcome of the arbitration proceedings.

Id. at 220. Nevertheless, the court did not refuse to allow the common law issues to go to arbitration, but stayed arbitration pending the court's resolution of the securities claims. *Id.*

123. 15 U.S.C. § 77n (1976). See text accompanying note 50 *supra*.

124. 15 U.S.C. § 78 cc(a) (1976). See note 68 and accompanying text *supra*.

125. An example of this reasoning is *Pawgan v. Silverstein*, 265 F. Supp. 898 (S.D.N.Y. 1967), in which plaintiff sought recovery for alleged violations of §§ 17(a) and 12(2) of the Securities Act, 15 U.S.C. §§ 77(q)(a), 77l(2) (1976), § 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) (1976), rule 10b-5, 17 C.F.R. § 240.10b-5 (1979), and § 352c of the General Business Law of New York, N.Y. GEN. BUS. LAW § 352c (McKinney 1968). 265 F. Supp. at 899. The state statute prohibited fraudulent practices in language similar to that of rule 10b-5. It was argued that because the pendent claims relied on a state statute patterned after the federal securities law, the court should read into the state statute the non-waiver provisions of the federal statutes. *Id.* at 901. The court rejected this argument, apparently reasoning that the statutory non-waiver provisions of the federal securities laws simply have no application to claims not based on those federal laws. *Id.*

A recent SEC release appears to agree with those cases permitting severance and arbitration of pendent state law claims. See Securities Exchange Act Release No. 15984, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,122, at 81,977.

126. *Kavit v. A.L. Stamm & Co.*, 491 F.2d 1176, 1181 (2d Cir. 1974).

127. 320 F. Supp. 598 (S.D.N.Y. 1970).

National Association of Securities Dealers, or the common law.¹²⁸ The court acknowledged that it was empowered to compel arbitration of the common law claims, but held that such relief was impractical, if not impossible, as the court could not separate the common law from the federal law issues.¹²⁹ The *Shapiro* court reasoned that it could not permit the defendant to thwart the exclusive jurisdiction of the federal courts over federal securities law claims by compelling arbitration of an ancillary dispute¹³⁰ and stated that whether certain issues were federal securities matters or claims at common law was a question best left for judicial resolution.¹³¹

The *Shapiro* result was accepted by the Fifth Circuit in *Sibley v. Tandy Corp.*,¹³² a case involving a contract for the merger of the P.J. Parker Company with the Tandy Corporation. Tandy refused to consummate the merger, charging that Parker's net worth was substantially less than represented.¹³³ Plaintiff, the representative of Parker's shareholders, brought an action against Tandy, charging four counts of breach of contract, one count of federal and state securities law violations, and one count of common law fraudulent misrepresentation.¹³⁴ The court directed that the contract clause be arbitrated and that the federal and state securities claims and the common law fraud claim be stayed pending the outcome of the arbitration proceedings.¹³⁵ Thus, while some pendent state claims were held arbitrable, the pendent claims of fraud were not.

128. *Id.* at 599-600.

129. *Id.* at 600.

130. *Id.*

131: *Id.*

The interesting point in *Shapiro* is that the complaint failed to plead each cause of action separately so that the court could determine the nature of the relief sought. Perhaps this apparent failure to satisfy the minimum pleading requirements of the Federal Rules of Civil Procedure, and not the mere similarity of the common law and securities claims, prompted the court to deny arbitration. See FED. R. CIV. P. 8(a), (e), 9(b). Rule 9(b), providing that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity," FED. R. CIV. P. 9(b), applies to the pleading of an action premised on rule 10b-5 as well as actions alleging common law fraud. *Walling v. Beverly Enterprises*, 476 F.2d 393, 397 (9th Cir. 1973); *Segel v. Gordon*, 467 F.2d 602, 608 (2d Cir. 1972). Thus, if the *Shapiro* Court had known exactly what claims were being made, and approximately what facts would be proven to support those claims, it may not have concluded that it was impossible to separate the common law issues from the federal issues.

132. 543 F.2d 540 (5th Cir. 1976), *cert. denied*, 434 U.S. 824 (1977). See also *Wick v. Atlantic Marine, Inc.*, 605 F.2d 166, 168 (5th Cir. 1979).

133. 543 F.2d at 541.

134. *Id.* at 542 n.1.

135. *Id.* at 544. In a footnote, the court also noted that in some situations arbitration should be stayed pending resolution of federal securities claims. *Id.* at 544 n.6. See *Frier Indus., Inc. v. Glickman*, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,845 (S.D.N.Y. 1974). Furthermore, if the claims are factually and legally independent, arbitration and trial may occur simultaneously. See *Sam Reisfeld & Son Import Co. v. S. A. Eteco*, 530 F.2d 679 (5th Cir. 1976); *Macchiavelli v. Shearson Hammill & Co.*, 384 F. Supp. 21 (E.D. Cal. 1974).

The court viewed the rule 10b-5 and common law fraud claims not as "intertwined" with the contract claims, but as "dependent" upon them.¹³⁶ The *Sibley* court concluded that the claims followed a logical sequence: first, a claim for specific performance of the contract for merger; second, an assertion that the contract was ambiguous and should be reformed; and third, that Parker was fraudulently induced by defendants' oral representations to enter into a written contract different than previous oral representations. In holding that all of the policy reasons supporting arbitration apply when arbitration may establish that a securities claim does not exist, the court stated that if the first or second contract claim was resolved in plaintiff's favor, the third claim would be moot.¹³⁷ The court reasoned that policies behind the Federal Arbitration Act and considerations of judicial economy required that Parker's contractual claim be submitted to arbitration and that the federal securities law claim be stayed pending the outcome of the arbitration.

The results reached by courts when presented with federal securities claims and pendent state claims in the presence of a predispute arbitration agreement underscore the extreme difficulty of reconciling the contradictory policies underlying the federal securities and arbitration acts. Under the current state of the law there can be no wholly satisfactory resolution of problems presented by the rule of law initially stated by *Wilko v. Swan*.

*Arbitration of Pendent State Law Claims
Is the Unsolved Problem*

Case law demonstrates that the inherent conflict between the federal securities acts and the Arbitration Act in the present legislative scheme presents a dilemma concerning the arbitration of pendent state law claims. Under existing statutory interpretation, federal securities claims are not arbitrable, while state claims may be fully arbitrable. When the state claim is present in the federal action because of pendent jurisdiction, a court can theoretically pursue the following alternatives. First, it could require all claims to be tried. Second, it could require all claims to be arbitrated. Third, it could require the securities claims to be tried and the pendent claims arbitrated. None of these alternatives is adequate.

The first alternative, trying all claims—chosen by the court in *Shapiro* and in part by the court in *Sibley*—simply ignores the contractual and statutory right to arbitration. While the *Sibley* holding was well-intentioned, its effect was to deny one party the right to arbitrate a dispute pursuant to an express contractual agreement. This result has no statutory basis under the securities laws or the Arbitration Act.

The second alternative—the arbitration of all claims—is contrary to the *Wilko* holding. Compelling arbitration of securities claims would coerce a

136. 543 F.2d at 543.

137. *Id.* at 543-44.

waiver of the right to litigate those claims in federal courts. Unless the securities acts are amended to permit waivers of rights through predispute arbitration agreements, or unless the courts are persuaded that arbitration agreements are not waivers at all because agreements can be devised that are fair and freely agreed to by informed customers, the second alternative is not available.

The third alternative—bifurcation of the federal and pendent state law claims—is the only viable alternative under the present securities and arbitration acts. Under the Federal Arbitration Act, courts are empowered to bifurcate an action presenting both arbitrable and nonarbitrable claims.¹³⁸ Courts also have discretion to stay either the trial or the arbitration until the happening of some occurrence or the resolution of the other proceedings.¹³⁹ Accordingly, if the arbitrable claims predominate over the securities claims, courts have stayed trial on the securities claims until arbitration of the pendent claims is concluded.¹⁴⁰ Conversely, where the securities claims predominate over arbitrable issues, courts have stayed arbitration until the securities issues were tried and resolved.¹⁴¹ Not surprisingly, this power to stay either proceeding is most effective where the arbitrable and nonarbitrable claims are factually and legally distinct because in such a case a second proceeding would not necessarily duplicate the prior hearing.¹⁴² Presumably, a court can effectively use this discretionary power when the first proceeding would resolve the entire dispute between the parties. The court in *Sibley* contemplated this result when it arranged the vari-

138. 9 U.S.C. § 3 (1976). See *Sibley v. Tandy Corp.*, 543 F.2d at 544; *Collins Radio Co. v. Ex-Cell-O Corp.*, 467 F.2d 995, 1000 (7th Cir. 1972); *Fox v. Merrill Lynch & Co.*, 453 F. Supp. 561, 567 (S.D.N.Y. 1978); *Tepper Realty Co. v. Mosaic Tile Co.*, 259 F. Supp. 688, 692 (S.D.N.Y. 1966).

139. In the cases cited in note 138 *supra*, trial was stayed pending arbitration. For cases in which arbitration of state claims was stayed pending resolution of federal securities claims, see note 141 *infra*.

140. See cases cited in note 138 *supra*.

141. *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831, 832 (7th Cir. 1977); *Greater Continental Corp. v. Schechter*, 422 F.2d 1100, 1103-04 (2nd Cir. 1970); *Frier Indus., Inc. v. Glickman*, [1974-1975 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 94,845, at 96,850; *Stockwell v. Reynolds & Co.*, 252 F. Supp. at 220. See also *Todd v. Oppenheimer & Co.*, 78 F.R.D. 415, 426 (S.D.N.Y. 1978) (where federal securities law claims involve factual questions that are essential elements of common law claims, arbitration before litigation is inappropriate). Accord, *Peacock v. Oppenheimer & Co.*, [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,201, at 96,587 (N.D. Ill. 1979).

142. *Mansbach v. Prescott, Ball & Turben*, 598 F.2d at 1030-31; *Sam Reisfeld & Son Import Co. v. S.A. Eteco*, 530 F.2d at 681; *DeHart v. Moore*, 424 F. Supp. at 57. In *Mansbach*, plaintiff investor alleged federal securities and state law claims arising out of identical facts. Having noted that allowing both arbitration and litigation would be clearly duplicative and possibly effective of inconsistent results, the Sixth Circuit instructed the district court that if it should find, on remand, that the requisite legal elements of the claims are substantially similar, it should determine both the state and federal claims. If the claims were not found to be legally similar, the district court was instructed to resolve the federal claims and stay arbitration of the state claims pending such resolution. 598 F.2d at 1030-31.

ous claims in a logical sequence and concluded that the resolution of one claim would render the remaining claims moot.¹⁴³

Despite its feasibility, bifurcation is not a satisfactory alternative. At best, invoking the discretionary power to stay a trial or arbitration undercuts the certainty that is normally desirable in securities cases. As this Article has shown, a decision to stay is apparently hit or miss, applied almost totally on an ad hoc basis. In addition, because the factual and legal basis of the arbitrable and nonarbitrable claims are identical in most securities cases,¹⁴⁴ the second forum would inevitably retrace the same evidentiary and legal questions already presented to the first forum. This duplication of time and effort is not only costly but vulnerable to the possibility of inconsistent results. Furthermore, although the *Sibley* court's hope that the first forum's resolution would end the entire dispute may have been reasonable in that case,¹⁴⁵ it is too tenuous an expectation to be the basis for any sound federal policy.¹⁴⁶ Certainly, an integrated federal policy regarding securities and arbitration rights should not be based on such a bald presumption.

Bifurcation also contradicts the very strong federal policy of pendent jurisdiction, which rests on the desire to have parties resolve their entire controversy in one proceeding.¹⁴⁷ Severance of factually and legally similar

143. See notes 136-137 and accompanying text *supra*.

144. See *Klaus v. Hi-Sheer Corp.*, 528 F.2d 225, 231 (9th Cir. 1975) (false and misleading statements in proxy solicitations made by directors constituted a violation of federal securities acts and breach of management's fiduciary duty to stockholders under California law); *Hidell v. International Diversified Inv.*, 520 F.2d 529, 536-37 & n.16. (7th Cir. 1975) (action against corporation alleging violations of both state and federal securities laws derived from common nucleus of facts so as to assert pendent jurisdiction even though federal claim was ultimately dismissed); *Hudak v. Economic Research Analysts, Inc.*, 499 F.2d 996, 1001 (5th Cir. 1974), *cert. denied*, 419 U.S. 1122 (1975) (federal and state securities claims derived from same operative facts so that pendent jurisdiction existed even though federal claim was ultimately dismissed because of the running of the statute of limitations); *Ferland v. Orange Groves of Florida, Inc.*, 377 F. Supp. 690, 703, 709 (M.D. Fla. 1974) (federal claim for sale of unregistered securities and state claim for fraud and deceit based on same factual situation). See notes 102-116, 127-137 and accompanying text *supra*. But see *Petersen v. Federated Dev. Co.*, 387 F. Supp. 355, 360 (S.D.N.Y. 1974) (where proof of plaintiff's state claim would involve facts relating to corporation's listing agreement with stock exchange but where such facts were not common to plaintiff's federal claims, state and federal claims did not derive from common nucleus of facts and court was without pendent jurisdiction); notes 115-118 and accompanying text *supra*.

145. See text accompanying note 137 *supra*.

146. For example, in *Macchiavelli v. Shearson, Hammill & Co.*, 384 F. Supp. 21 (E.D. Cal. 1974), the rule 10b-5 claim based on the broker's alleged misrepresentation of the investor's financial status to another broker would certainly not have been settled by the arbitrator's decision on the breach of contract claim. See notes 102-116 and accompanying text *supra*.

147. Federal courts have the power to assume pendent jurisdiction whenever there is a substantial federal claim and the relationship between it and the asserted state claim permits the conclusion that the entire action before the court comprises one constitutional case. See *generally* *UMW v. Gibbs*, 383 U.S. 715, 725 (1966). Although the Federal Rules of Civil Procedure do not expand federal jurisdiction, FED. R. CIV. P. 82, to the extent that they require plaintiffs to try their entire case at one time, they embody policies aligned with the theory underlying pendent jurisdiction. 383 U.S. at 725 n.13. Although pendent jurisdiction is a matter of judicial discretion, *id.* at 726; *Nolan v. Meyer*, 520 F.2d 1276, 1286 (2d Cir.), *cert. denied*, 423 U.S.

claims will almost inevitably result in duplication of time and effort and prejudice to the parties who are forced to litigate their controversy in a piecemeal fashion.¹⁴⁸ Inherent danger also awaits a party compelled to try his or her case a second time, after a portion of the case has been decided in another forum. Bifurcation and pendent jurisdiction, therefore, simply are not compatible legal theories.

PROBLEMS AND SOLUTIONS TO THE ENFORCEMENT
OF PREDISPUTE ARBITRATION AGREEMENTS

The present use of predispute arbitration agreements in the securities industry is neither evenhanded nor uniform in wording or application. Many provisions do not provide full and fair disclosure to the investor regarding the possible meanings and ramifications of the arbitration provisions.

The SEC has articulated three major areas of concern surrounding arbitration agreements.¹⁴⁹ First, because arbitrators are affiliated with the self-regulatory exchanges,¹⁵⁰ investors hesitate to use arbitration facilities because they believe that the procedure will be impartial.¹⁵¹ Second, the arbitration procedure is too complex for the typical investor to handle on his or her own without counsel. Finally, the arbitration fees can become prohibitively expensive.¹⁵² Moreover, predispute arbitration clauses are, in

1034 (1975), as long as the claims derive from a common nucleus of operative facts, courts will normally exercise jurisdiction over the pendent claims. *Hagans v. Lavine*, 415 U.S. 528, 545 (1974); *UMW v. Gibbs*, 383 U.S. at 725; *Almenares v. Wyman*, 453 F.2d 1075, 1083 (2d Cir.), *cert. denied*, 405 U.S. 944 (1971). The test for determining pendent jurisdiction is essentially whether substantially the same evidence will prove both federal and nonfederal claims. *See Vanderboom v. Sextan*, 422 F.2d 1233, 1241 (8th Cir. 1970); *Knuth v. Erie-Crawford Dairy Coop. Ass'n*, 395 F.2d 420 (3d Cir. 1968).

A disposition exists to retain state claims under federal jurisdiction, derived from a deference shown to federal laws in certain areas, a desire to have parties litigate their entire controversy at once, and a supposition that the pendent state law claim is somewhat inferior. Beginning with *Gibbs*, several policy arguments have been offered in support of a permissive doctrine of pendent jurisdiction. In *Gibbs*, the Supreme Court grounded the justification for pendent jurisdiction upon considerations of judicial economy, convenience, and fairness to the litigants. 383 U.S. at 726. *See Hagans v. Lavine*, 415 U.S. at 545. Indeed, the Court in *Gibbs* stated that if a case does not present these three concerns, "a federal court should hesitate to exercise jurisdiction over state claims, even though bound to apply state law to them." 383 U.S. at 726, *citing* *Erie R.R. v. Thompkins*, 304 U.S. 64 (1938).

148. *Garza v. Chicago Health Clubs, Inc.*, 347 F. Supp. 955, 961 (N.D. Ill. 1972).

149. *See* Exchange Act Release No. 13470, *Implementation of an Investor Dispute Resolution System*, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,136, at 87,906.

150. *See* *Richards v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 64 Cal. App. 3d 889, 135 Cal. Rptr. 26 (1976).

151. *See* Exchange Act Release No. 13470, *Implementation of an Investor Dispute Resolution System*, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,136, at 87,906. *See also* Smith, *Breaking the Chains that Bind: Arbitration Agreements Versus Forum Rights Under the Commodity Futures Trading Commission Act of 1974*, 16 SAN DIEGO L. REV. 749 (1979).

152. *See* Exchange Act Release No. 13470, *Implementation of an Investor Dispute Resolution System*, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,136, at 87,906.

many cases, a compulsory prerequisite for doing business in the market.¹⁵³ For these reasons, predispute arbitration agreements must be re-examined.¹⁵⁴

In an attempt to address these concerns, the Securities Industry Conference on Arbitration has been engaged since 1977 in developing and implementing uniform, fair and efficient arbitration procedures for investor-broker disputes.¹⁵⁵ Any proposals made by this group should at least satisfy the following conditions promulgated by the Commodity Futures Trading Commission (CFTC)¹⁵⁶ for the enforceability of predispute arbitration agreements under the Commodity Exchange Act:¹⁵⁷

1. That signing the agreement not be made a condition of access to the market;
2. That the customer sign separately the clause providing for arbitration; and
3. That there be a warning in bold face type that the customer is giving up certain rights to assert his claim in court.¹⁵⁸

153. See Commodity Futures Trading Comm'n, *Oral Hearing on Arbitration and other Dispute Settlement Procedures* (March 5, 1976); 41 Fed. Reg. 27,526 (1976); 41 Fed. Reg. 42,944-45 (1976). The conclusion of the Commodity Futures Trading Commission is particularly relevant to this Article because to an increasing extent the public investor is diversifying both as to portfolio and as to the nature of financial instruments in which funds are committed.

154. In a recent release, Securities Exchange Comm'n Release No. 34-15984, *SEC Warning to Broker-Dealers Concerning Arbitration Clauses in Customer Agreements*, BNA No.510, at J-1 (1979), the SEC warned broker-dealers that the continued use of predispute arbitration clauses without releasing adequate information to investors is both inequitable and possibly violative of the anti-fraud provisions of the federal securities laws. *Id.* The Commission noted that recent cases complied with *Wilko's* protection of the investor's right to a judicial forum, but that inadequate and unexplained arbitration clauses were still prevalent in customer agreements. *Id.* at J-2.

155. Exchange Act Release No. 13470, *Implementation of an Investor Dispute Resolution System*, [1977-1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,136, at 87,905. The Office of Consumer Affairs established by the Commission recommended a program for resolution of disputes between individual investors and broker-dealers. The cogent points of the program were:

1. Institution of in-house customer complaint processing systems by brokerage firms.
2. Drafting of a uniform code of arbitration.
3. Establishment of a network of "small claims adjusters" to settle customer claims under \$1,000.

Id. at 87,906-07. The Securities Industry Conference on Arbitration has developed a simplified arbitration procedure for resolving customer claims of \$2,500 or less and a Uniform Code of Arbitration. See *Third Report of the Securities Industry Conference on Arbitration to the Securities and Exchange Commission* (January 31, 1980).

156. See 17 C.F.R. § 180 (1979).

157. See Commodity Exchange Act, 7 U.S.C.A. §§ 7a(11), 12a (Supp. 1979). The Act was recently amended, Pub. L. No. 95-405, § 11, 92 Stat. 870 (1978), to authorize, but not require, the contract market to delegate its responsibilities to a registered futures association having standardized rules and arbitration procedures. See 7 U.S.C.A. § 7(a)(11) (Supp. 1979). This would allow for a more centralized arbitration program for customer claims in lieu of the different systems currently maintained by various contract markets.

158. 17 C.F.R. § 180.3(b) (1979).

The satisfaction of these conditions renders predispute arbitration agreements under the Commodity Futures Trading Commission Act enforceable.¹⁵⁹ It must be noted, however, that the Commodity Futures Trading Commission Act expressly addresses the arbitration of customer disputes¹⁶⁰ by requiring that each contract market "provide a fair and equitable procedure through arbitration or otherwise" for the settlement of customers' claims up to \$15,000,¹⁶¹ and that "the use of such procedures by a customer shall be voluntary."¹⁶² The federal securities acts, however, do not specifically mention arbitration of customers' disputes, and thus an amendment of the securities acts may be necessary in order to provide the SEC with the option to develop regulations similar to those promulgated by the CFTC. The implementation in securities disputes of the conditions required by a Commodities Commission agreement would go a long way toward closing the gap currently left open in the securities area.

Most important in formulating acceptable arbitration procedures is the retention of the public's confidence in the securities markets generally and in dispute resolution specifically. This confidence can only be earned by maintaining both a *de facto* as well as a *de jure* image of fairness in arbitration procedures.¹⁶³ One certain barrier to public confidence in arbitration is the "basic unfairness in requiring the nonmembers [the public investor] to submit [disputes] to arbitrators, all of whom have been appointed [or selected] by the Exchange," of which brokerage firms are members.¹⁶⁴

Both individual investors and exchange members have vital rights and interests regarding the question of who shall exercise direct authority and control over the sponsorship and conduct of arbitral forums and proceedings. It logically follows that all sectors must have an equal representation and voice in the formulation of arbitration rules and proceedings.

CONCLUSION

Investors in securities require the ready availability of a forum in which disputes can be resolved in a speedy and impartial manner. Delay can be

159. See *Protzko v. Shearson Hayden Stone, Inc.*, [1980 Current Binder] COMM. FUT. L. REP. (CCH) ¶ 20,800, at 23,258 (1979) (predispute arbitration agreement that does not comply with the requirements of § 180.3 of Commodity Futures Trading Commission Regulations may not be used as basis for arbitration proceeding and complainant is not prejudiced with regard to reparations); *Ames v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 567 F.2d 1174 (2d Cir. 1977), reversing 76 Civ. 3085 (S.D.N.Y. March 21, 1977) (condition of regulation must be met in all predispute arbitration agreements, not only those specifically mentioned in the Act).

160. 7 U.S.C.A. § 7a(11) (Supp. 1979). See *Milani v. Conti Commodity Serv., Inc.*, 462 F. Supp. 405 (N.D. Cal. 1976) (interpretation of § 7a(11)).

161. 7 U.S.C.A. § 7a(11) (Supp. 1979).

162. *Id.*

163. Statement of Constantine N. Katsoris before the Securities and Exchange Commission (Dec. 8, 1977).

164. *Richards v. Merrill Lynch, Pierce, Fenner & Smith*, 64 Cal. App. 3d 899, 903, 135 Cal. Rptr. 26, 28 (1976).

tantamount to a denial of due process and unnecessary exposure to market risk. Arbitration represents the only remedy that provides a meaningful dimension of due process without the prohibitive costs, delay, and protraction of litigation. When weighed against the potential dilution and waiver of certain substantive legal rights, arbitration should be found to be an acceptable manner of resolving securities disputes. Accordingly, once clear, unambiguous and fair arbitration provisions are formulated, *Wilko v. Swan* must be overruled.

