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A COMMENT ON JUDGE SELYA'S *ARBITRATION UNBOUND?: THE LEGACY OF* McMAHON*

Stephen J. Friedman†

INTRODUCTION

I should begin with the customary disclosure of my background and prejudices in the area. I was a member of the Ruder Task Force,[1] but the views expressed today are, of course, solely my own. While in private practice, I have not personally represented either plaintiffs or defendants in securities arbitrations. However, in my former lives as general counsel of a large retail securities firm and of a large retail life insurance company, both of which were substantial users of the arbitration mechanism, I was responsible for overseeing the defenses of a large number of arbitrations. Additionally, as an SEC Commissioner and later as Governor of the National Association of Securities Dealers ("NASD"), I had some responsibility for overseeing the arbitration process.

I am fascinated by Judge Selya's analysis of *Shearson/American Express, Inc. v. McMahon*[2] and the competition between our judicial system and the extensive and unique arbitral system that has grown up in the securities industry, largely under the auspices of the NASD. He concludes that most of the shortcomings that concerned the *Wilko v. Swan*[3] Court remain unresolved. Additionally, he sees a convergence of the two dispute resolution mechanisms. Judge Selya's gloomy conclusion is that securities arbitrations are acquiring many of the most criticized aspects of civil litigation and that the judicial system is becoming more streamlined and efficient. This analy-

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[1] *See* NATIONAL ASSOCIATION OF SECURITIES DEALERS, SECURITIES ARBITRATION REFORM: REPORT OF THE ARBITRATION POLICY TASK FORCE (1996) [hereinafter TASK FORCE REPORT].

[2] 482 U.S. 220, *reh'g denied*, 483 U.S. 1056 (1987).

[3] 346 U.S. 427 (1953).

sis reflects, I think, a world view from the somewhat conceptual vantage point of an appellate judge. Yet, in my judgment, the present securities industry arbitral system is uniquely rooted in the day-to-day facts of the special relationship between retail securities firms and their customers. It is primarily that relationship, with the very "human" kind of problems that arise, with which the arbitration system was designed to deal and for which, I would submit, it remains greatly superior to the judicial system.

With that in mind, I would like to set out for critical examination a set of factual and policy propositions that illuminate the reasons why I believe that both mandatory arbitration and the recommendations of the Task Force Report remain the right course of action.

Many investors do not adequately understand investment risk.

Notwithstanding even good faith efforts, it is difficult to communicate the nature of investment risk. Individual investors often do not understand the nature of, and ignore warnings of, investment risk. They are commonly surprised and sometimes even outraged when the value of an investment goes down. A truly astonishing number of presumptively "sophisticated" investors have difficulty understanding why the value of a portfolio of Treasury securities, which carry no credit risk, decreases when interest rates rise.[4]

Most brokers are trained and function as salesmen.

Most importantly, brokers are compensated as salesmen—they are paid a commission on revenues. As a consequence, their financial interest lies in "making the sale" rather than in preserving and increasing value over time. The smarter brokers know that the short-term approach is only of short-term value, to them as well as to their customers, and that pursuing their customers' long-term interests is the best way to maintain the flow of commissions. But many do not understand that, and their compensation system pushes them in the

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[4] *See generally* INVESTMENT COMPANY INSTITUTE, SHAREHOLDER ASSESSMENT OF RISK DISCLOSURE METHOD (1996).

other direction. Although the securities laws impose obligations of fairness, suitability and disclosure upon brokers in dealing with their customers, commission salesmen tend to be driven by their compensation system.

There are some bad actors as well.

In spite of the efforts of the SEC, the NASD, the New York Stock Exchange and the other self-regulatory organizations to eliminate the bad apples from the securities industry, there always seems to be a small number of them in the industry, and their potential for causing damage is out of proportion to their numbers. When I was an SEC Commissioner, a small but unremitting portion of the enforcement cases involved over-aggressive salesmen who had migrated into the securities industry from unregulated high-pressure sales roles. And the growth of the penny-stock market was fertile ground for this group.[5]

Customer disputes are inevitable.

Notwithstanding the honesty and concern for customers that characterize most brokers, when the equity markets go down, or when interest rates move up and the value of fixed income securities moves down, customer disputes burgeon. When dishonest brokers are involved, disputes arise no matter how the markets are doing. The reality is that customer disputes are part and parcel of the retail securities business.

Many customer disputes are small.

The NASD now handles about eighty-five percent of all self-regulatory organization arbitrations and about seventy-five percent of all securities-related arbitrations.[6] That amounts to about 6,000 cases per year at the current rate.[7] Of those, about fifty percent involve less than $50,000 in "real" claimed

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[5] *See, e.g.*, *In re* Kenneth J. Schulte, *SEC Administrative Procedures*, 1997 SEC LEXIS 788 (Apr. 10, 1997).

[6] *See* TASK FORCE REPORT, *supra* note 1, at 138.

[7] *See* TASK FORCE REPORT, *supra* note 1, at 138.

damages (excluding punitive damages). Thus, there are about 3,000 cases per year involving small amounts in which the feelings of the customer run so high, or the securities firm has taken such a hard line, that settlement has not been possible. There is a significant public policy interest, which is matched by the securities industry's interest in maintaining the good will of customers, in resolving those cases quickly and at low cost.

The courts are wholly unsuited to deal with the small cases.

In general, neither plaintiffs nor defendants want to use the judicial system for small cases unless it is plainly to their advantage to do so. Litigating in court is too expensive, cumbersome and slow. Although Judge Selya cites some interesting data for federal courts,[8] most of these cases will be litigated in state court, where the docket backlog varies widely from state to state. The Supreme Court's decision in *Ernst & Ernst v. Hochfelder*,[9] requiring that a plaintiff show scienter to make out a claim under Rule 10b-5, has caused many plaintiff's counsel to shift to state courts where the burden of proof is often lower.

Plaintiffs prefer the judicial system in those cases in which access to a jury holds out the promise of a large award—and thus a large settlement. Cases involving potentially large punitive damages are the most common example of cases in which plaintiff's counsel prefer a jury trial. In contrast, defendants prefer the judicial system when their position (as is often the case) depends more on the law than on the facts,[10] or sometimes when the greater cost (and the defendant's greater resources) is an advantage due to the defendant's deeper pocket. When the defendant's case is based upon technical legal provisions, such as statutes of limitations, they feel disadvantaged before arbitrators who often tend to "do equity" for investors regardless of the defendant's strict legal rights.

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[8] *See* TASK FORCE REPORT, *supra* note 1, at 201 (noting that even in Federal Court, the NASD arbitration process is significantly faster and much less expensive).

[9] 425 U.S. 185 (1976).

[10] *E.g.*, "the customer is required to read the warnings in a prospectus," or "New York is a true employment-at-will state."

Neither plaintiffs nor defendants should be able to choose a forum based on whether the facts of the particular case mean one forum would be "better" than another.

Because arbitration is a consensual process, those who appeared before the Task Force who ordinarily represent investors in disputes with securities firms often took the position that consent should be given only at the time the dispute arises. They pointed out that most securities firms have pre-dispute arbitration clauses in their new account forms for margin accounts. They argued that the pervasiveness of those agreements amounts to de facto mandatory arbitration, notwithstanding the enhanced disclosure recommended by the Task Force Report.[11] I agree with that characterization but not with the conclusion. Once the facts of a dispute are known, one party is likely to know that the judicial system would be a better forum for its position, and the other party will know the opposite. Agreement is unlikely, and the forum will be chosen not by consent but by default—that is, whatever forum is required or permissible in the absence of agreement. The rules of the NASD and the other self-regulatory organizations provide that, absent a pre-dispute arbitration agreement between the parties, the customer can compel arbitration, which means that the customer can choose the forum.[12] Thus the effect of banning pre-dispute arbitration agreements would always be to permit the customer to choose the forum.

I think that greater fairness is achieved if a pre-dispute arbitration agreement is signed at a time when neither party knows what kind of dispute will arise and who will benefit from arbitration[13]—whether denying the ability of the securities firm to assert legal issues and to beat down the plaintiff with endless discovery will prove a great benefit to the plaintiff, or denying the ability of a plaintiff to present evidence of serious misconduct to a jury will benefit the defendant. By

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[11] "You either sign it, or they don't want your business." Theodore A. Krebsbach et al., *Pre-Dispute Arbitration Agreements*, 63 FORDHAM L. REV. 1511, 1519 (1995) (comments of Theodore Eppenstein).

[12] NASD, CODE OF ARBITRATION PROCEDURE § 12(a)(i)(2) (1996); N.Y.S.E. GUIDE (CCH) Rule 6cc(a) (1995).

[13] *Cf.* JOHN RAWLS, A THEORY OF JUSTICE (1971).

permitting pre-dispute arbitration clauses we are saying, in effect, that in most cases arbitration will be better for both sides. It is better because it will be faster and cheaper and, for the investors, more equitable than a judicial forum which would pay more heed to legal technicalities.

The process of judicializing the arbitration process is at a very early stage.

Much has been made of the "legalization" of the arbitration process. Indeed, the Task Force Report has a number of suggestions, including mandatory discovery, that nudge arbitration in the direction of the judicial system.[14] But the fact remains that discovery in arbitration simply bears no relationship to discovery in the judicial system. There are, for example, ordinarily no depositions.[15] Document discovery in most cases is extremely limited. Judge Selya at one point seems concerned that the things the *Wilko* Court criticized about arbitration—the lack of reasoned and written opinions and of an effective appeal, for example—remain defects in the arbitration system. Yet, at the same time he criticizes the legalization of the system. We cannot have it both ways, and there is much to be said for the proposition that it is the very search for exquisite procedural fairness that has produced a judicial process so cumbersome that ordinary people want to avoid using it for dispute resolution. There is no doubt that further legalization is inevitable in complicated arbitrations. But the Task Force Report was careful to preserve the old, single-arbitrator, streamlined process for cases under $30,000, which would account for thirty-five percent of all claims,[16] and would permit the same procedures to apply to claims up to $50,000 with the consent of the parties.[17]

Similarly, Judge Selya seems to criticize the Task Force Report's recommendation for early neutral evaluation—not because it is a bad idea, but because it is too much like what is used for litigation and, in effect, should not be needed in arbi-

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[14] *See* TASK FORCE REPORT, *supra* note 1, at 82.
[15] NASD ARBITRATOR'S MANUAL 10 (1992).
[16] *See* TASK FORCE REPORT, *supra* note 1, at 72-73.
[17] *See* TASK FORCE REPORT, *supra* note 1, at 75.

tration. But arbitration, like litigation, represents a breakdown in the ordinary day-to-day human mechanisms for resolving disputes. Both sides are often angry and insulted. It is not a criticism of the arbitration process that third-party intervention can be useful in helping the parties to resolve the dispute outside of an adversary process.

In sum, it is simply not the case that the Hotelling Paradox has driven the courts and arbitration into a situation where "distinctions blur, and we are left with one dish that, while edible, retains none of the spices that distinguished the two predecessors."[18] The fact is that in most cases, all parties recognize that arbitration remains faster, cheaper and generally more fair—and all parties prefer it, except in particular cases in which the judicial system presents more individual advantage.

Arbitration is a place to go to have your rights determined.

Finally, and perhaps most important, too many Americans do not regard the courts as a place where it is possible to go to have their rights determined. And the determination of those rights is the most fundamental social function of the courts. Indeed, the pressure for settlement from judges is fierce and sends a clear message to litigants about the attitude of the courts toward performing this basic function. In the broker-customer environment, in which disputes are bound to arise, there is thus a critical social function served by an institution provided to determine those rights relatively quickly and inexpensively. Arbitration, although heavily subsidized by the securities industry, is generally perceived as a fair process to achieve that end.[19]

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[18] Bruce M. Selya, *Arbitration Unbound?: The Legacy of* McMahon, 62 BROOK. L. REV. 1433, 1447 (1996).

[19] *See* UNITED STATES GENERAL ACCOUNTING OFFICE, SECURITIES ARBITRATION: HOW INVESTORS FARE 31 (GAO/GGD-92-74) (May 1992).