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Federal and State Securities Claims: Litigation or Arbitration?—Dean Witter Reynolds, Inc. v. Byrd, 105 S. Ct. 1238 (1985)

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FEDERAL AND STATE SECURITIES CLAIMS: LITIGATION OR ARBITRATION?—*Dean Witter Reynolds, Inc. v. Byrd,* 105 S. Ct. 1238 (1985).

An investor-broker agreement typically contains an arbitration clause.[1] Thus, as a practical matter, an investor must agree to arbitrate future disputes as a condition of doing business with a broker-dealer.[2] An arbitration clause is not enforceable for claims arising under the Federal Securities Act of 1933[3] or the Federal Securities and Exchange Act of 1934.[4] State securities law claims, however, are subject to arbitration under the Federal Arbitration Act.[5]

The federal courts of appeals were divided on the best method to resolve the conflict between the federal securities acts and the Federal Arbitration Act which occurred when nonarbitrable federal securities claims were joined with arbitrable state securities claims. Some circuits separated the claims and permitted litigation of the federal claims and arbitration of the state claims;[6] others permitted litigation of both federal claims and pendent state claims.[7]

In *Dean Witter Reynolds, Inc. v. Byrd,*[8] the Supreme Court held that arbitrable state claims pendent to federal securities claims must be arbitrated upon the request of either party.[9] The Court stressed that the Act mandates that courts direct the parties to arbitrate issues when a valid arbitration contract has been signed. In a concurring opinion, Justice White raised the issue of whether federal securities laws prohibit arbitration of section 10(b) claims under the Exchange Act.[10]

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1. Arbitration has long been a common method of settling disputes on securities exchanges. Comment, *Arbitration of Investor-Broker Disputes,* 65 CALIF. L. REV. 121–22 (1977). *See generally* Hoellering, *Arbitrability of Disputes,* 41 BUS. LAW 125 (1985).

2. Katsoris, *Arbitration of a Public Securities Dispute,* 53 FORDHAM L. REV. 279, 292 (1984).

3. Securities Act of 1933, Pub. L. No. 22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77(a)–77(aa) (1982)) [hereinafter referred to as Securities Act].

4. Securities Exchange Act of 1934, Pub. L. No. 291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78(a)–78(kk) (1982)) [hereinafter referred to as Exchange Act].

5. Act of 1925, Pub. L. No. 401, 43 Stat. 883 (codified as amended at 9 U.S.C. §§ 1–14 (1982)) [hereinafter referred to as the Arbitration Act or the Act].

6. *See, e.g.,* Liskey v. Oppenheimer & Co., 717 F.2d 314 (6th Cir. 1983).

7. *See, e.g.,* Byrd v. Dean Witter Reynolds, Inc., 726 F.2d 552 (9th Cir. 1984), *rev'd,* 105 S. Ct. 1238 (1985); Raiford v. Buslease, Inc., 745 F.2d 1419 (11th Cir. 1984); Miley v. Oppenheimer & Co., 637 F.2d 318 (5th Cir. 1981).

8. 105 S. Ct. 1238 (1985).

9. *Id.* at 1244.

10. *Id.* (White, J., concurring) (referring to 15 U.S.C. §§ 77(a)–77(aa) (1982)). Section 10(b) of the Exchange Act prohibits misrepresentations or material omissions in the purchase or sale of a security. Securities and Exchange Commission Rule 10b-5 was promulgated under section 10(b). Throughout this Note, references to section 10(b) will include issues raised under Rule 10b-5.

This Note analyzes *Byrd* in light of the dilemma that occurs when federal and state claims arise in the same action. The Note concludes that, although *Byrd* may be a step in the right direction, the current state of the law is still not satisfactory. Because arbitration offers several advantages to the investor,[11] this Note argues that both federal and state securities claims should be arbitrated. The Note suggests that either Congress change the law to allow arbitration of the federal claims, as Justice White proposed, or the Court allow arbitration of section 10(b) claims, or even of claims brought under the Securities Act.

To ensure that investors are properly protected in the arbitration tribunal, however, substantial changes must be made in the arbitration process. Therefore, this Note proposes that Congress, the courts, and the industry itself act to make arbitration more fair to investors. Until the Court is convinced that arbitration proceedings provide adequate investor protection, it should continue to require litigation of federal claims in federal court.

I. BACKGROUND

A. The Federal Arbitration Act

Congress passed the Federal Arbitration Act in 1925[12] to cure judicial hostility toward arbitration agreements.[13] Prior to the Act's passage, many courts would not enforce the terms of arbitration agreements.[14] The Act requires arbitration under predispute agreements,[15] but applies only to contracts involving interstate commerce.[16] Since securities violations

11. The primary benefits of arbitration include speed, efficiency, and relatively low cost. Arbitration has been estimated to cost less than one-third of what litigation costs, and most arbitration proceedings are completed within six months. Meyerowitz, *The Arbitration Alternative*, 71 A.B.A. J. 78, 80 (1985). Another advantage of arbitration is the ability of parties to choose their own "judge." *See* Sterk, *Enforceability of Agreements to Arbitrate: An Examination of the Public Policy Defense*, 2 CARDOZO L. REV. 481, 486 (1981).

12. Act of 1925, Pub. L. No. 401, 43 Stat. 883 (codified as amended at 9 U.S.C. §§ 1–14 (1982)).

13. *See* S. REP. No. 536, 68th Cong., 1st Sess. 2–3 (1924).

14. *See, e.g.*, Cocalis v. Nazilides, 308 Ill. 152, 139 N.E. 95 (1923) (predispute agreement void as depriving parties of right of access to the courts as provided in the Constitution).

15. This Note is limited to predispute arbitration agreements. An investor and broker may also agree to submit an existing controversy to arbitration. *See* Krause, *Securities Litigation: The Unsolved Problem of Predispute Arbitration Agreements for Pendent Claims*, 29 DE PAUL L. REV. 693, 694 (1980).

16. 9 U.S.C. § 2 (1982) provides:

> 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.

usually involve interstate commerce, all securities claims are potentially subject to the Act.[17]

Congress has long favored arbitration as a method of dispute resolution.[18] As courts' dockets become more crowded, courts too have been more open to arbitration as a method of dispute resolution.[19] Courts liberally interpret the scope of an arbitration clause.[20] The Act, however, limits a court's role to that of determining whether the party seeking arbitration has raised an issue that is within the scope of the arbitration agreement.[21] The policy favoring arbitration is so strong that the Supreme Court held that a California statute prohibiting arbitration was invalid.[22] Thus, if a securities claim involving interstate commerce is brought under state law alone and the investor signed an arbitration agreement, the claim cannot be heard in state court, but must be arbitrated.[23]

B. Federal Securities Acts

In *Wilko v. Swan*,[24] an investor sued his brokerage firm under section 12(2) of the Securities Act[25] for misrepresentations and omissions

17. Although an arbitration clause may state that it is governed by state law, it is settled that because of the supremacy clause, the Act controls. *See* Georgia Power v. Cimarron Coal Corp., 526 F.2d 101, 107 (6th Cir. 1975), *cert. denied*, 425 U.S. 952 (1976).

18. *See* H.R. REP. No. 96, 68th Cong., 1st Sess. 1–2 (1924).

19. *See, e.g.*, Southland Corp. v. Keating, 465 U.S. 1 (1984); Scherk v. Alberto-Culver Co., 417 U.S. 506, 510–11 (1974); Stateside Mach. Co. v. Alperio, 591 F.2d 234, 240 (3d Cir. 1979).

20. Hanes Corp. v. Millard, 531 F.2d 585, 598 (D.C. Cir. 1976); Galt v. Libbey-Owens Ford Glass Co., 376 F.2d 711, 714 (7th Cir. 1967).

21. 9 U.S.C. § 3 (1982). The Act is limited by legal and equitable doctrines that permit revocation of contracts. For example, when an allegation of fraud challenges the validity of the arbitration agreement, the court may permit litigation of the dispute rather than submit it for arbitration. Moseley v. Electronic & Missile Facilities, Inc., 374 U.S. 167 (1963) (prime contractor engaged in fraudulent scheme by inserting arbitration clause into contract).

22. Southland Corp. v. Keating, 465 U.S. 1 (1984) (California franchise investment statute, which prohibited waiver of the right to litigate in state court, directly conflicted with the Federal Arbitration Act in violation of the Supremacy Clause); *accord*, Garmo v. Dean Witter Reynolds, Inc., 101 Wn. 2d 585, 681 P.2d 253 (1984) (Court adopted the analysis of *Southland* and concluded that Congress enacted the Federal Arbitration Act to prevent state legislative attempts to undercut the enforceability of arbitration agreements).

23. *See* Southland Corp. v. Keating, 465 U.S. 1 (1984).

24. 346 U.S. 427 (1953).

25. Section 12(2) of the Securities Act provides that:

> Any person who offers or 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 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

concerning the sale of stock. The Supreme Court held that the predispute arbitration clause in the investor's brokerage agreement was void under the Arbitration Act.[26] The Court concluded that an investor cannot waive the right granted by the Securities Act to bring suit in federal court.[27]

The Court relied on a number of factors in disallowing arbitration agreements. First, it was concerned about inequality of bargaining power. Since the Securities Act contains an express policy of protecting the investor,[28] the Court concluded that section 12(2) was created to grant investors a "special right" to litigate in federal court.[29] The Court emphasized that a broker has the burden of proving lack of scienter under section 12(2). This burden might not be imposed by an arbitrator.[30]

The Court also relied on the language of the Securities Act regarding contrary stipulations.[31] Section 14 of the Securities Act provides: "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void."[32] The Court concluded that this language invalidated arbitration agreements regarding federal securities claims. Finally, the Court was concerned about the ability of arbitration to adequately deal with investor complaints.[33]

Litigation in federal court under the securities acts has several advantages for the investor. First, the investor receives a wide choice of venue[34] and nationwide service of process.[35] Second, a court's reasoning will usually be in writing. An arbitrator is not required to provide reasons for the decision unless the parties to the arbitration so stipulate.[36] Finally, a full range of judicial review is available. An arbitrator's decision is subject to limited judicial review.[37] After arbitration, only a "gross abuse of discretion" or a case of bias or corruption will receive judicial review.[38]

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such security from him . . . .

15 U.S.C. § 771(2) (1982).

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

27. *Id.*

28. Securities Act of 1933, Pub. L. No. 73-22, Preamble, 48 Stat. 74.

29. *Wilko*, 346 U.S. at 431. Section 12(2) does not state that investors have special rights and such language is not found in the congressional history of § 12(2).

30. *Id.* at 436.

31. *Id.* at 434.

32. 15 U.S.C. § 77n (1982). The language is substantially identical to that in the Exchange Act.

33. *Wilko*, 346 U.S. at 436.

34. 28 U.S.C. §§ 1391–1407 (1982).

35. FED. R. CIV. P. 4(c), (d).

36. *See* Comment, *supra* note 1, at 129.

37. Sterk, *supra* note 11, at 483.

38. The Federal Arbitration Act specifies the following as permissible grounds for vacating an arbitrator's award: (1) fraud, corruption, or undue means in procuring the award; (2) partiality or corruption on the part of the arbitrator; (3) misconduct by the arbitrator in refusing to permit a

The *Wilko* Court recognized that its holding was inconsistent with the underlying policy of the Act. The Court must have reasoned, however, that the protection of innocent, unknowledgeable investors was more important than the economic advantage of arbitration.

C. *Pre-*Byrd *Treatment of Joint Federal and State Securities Claims*

The courts prior to *Byrd* disagreed about how to resolve the problem that occurred when investors sued brokers for both nonarbitrable federal claims and arbitrable state claims. When both federal and state claims arose in the same action, some courts severed the action, entertaining the federal claims while referring the state claims to arbitration.[39] Other courts allowed litigation of both the federal claim and the pendent state claim.[40]

1. *Federal Court Litigation of Both Claims: The Intertwining Doctrine*

Under the intertwining doctrine, federal courts could refuse to submit state claims to arbitration when the facts that proved the state claims were substantially the same as the facts that proved the federal claims.[41] The intertwining doctrine is premised on two arguments. First, pendent state and federal claims should be tried together to avoid possible collateral estoppel effect of arbitration on the nonarbitrable claims. Collateral estoppel would threaten the exclusive jurisdiction of the federal courts over these claims.[42] Second, to proceed with litigation in addition to arbitration is inefficient and frustrates the Arbitration Act's purpose of fast and inexpensive resolutions.[43]

The Ninth Circuit adopted the intertwining doctrine in *Byrd v. Dean Witter Reynolds, Inc.*[44] In *Byrd,* the plaintiff brought an action alleging

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continuance of the hearing; (4) refusal by the arbitrator to hear pertinent evidence; and (5) action by the arbitrator in excess of his power. 9 U.S.C. § 10 (1982).

Moreover, courts often apply collateral estoppel to decisions rendered in arbitration proceedings. *See, e.g.,* Greenblatt v. Drexel Burnham Lambert, Inc., FED. SEC. L. REP. (CCH) ¶ 92,200 (8th Cir. June 25, 1985)(arbitrator's findings that no predicate acts supported federal racketeering violations given collateral estoppel effect on federal court proceedings). Since collateral estoppel may allow the investor only one opportunity to seek redress, it is vitally important that arbitration be made an adequate method of dispute resolution.

39. *See, e.g.,* Macchiavelli v. Shearson, Hamill & Co., 384 F. Supp. 21, 30 (E.D. Cal. 1974).

40. *See infra* notes 42–48 and accompanying text.

41. *See, e.g.,* Byrd v. Dean Witter Reynolds, Inc., 726 F.2d 552, 554 (9th Cir. 1984), *rev'd,* 105 S. Ct. 1238 (1985).

42. Miley v. Oppenheimer & Co., 637 F.2d 318, 336 (5th Cir. 1981); Sibley v. Tandy Corp., 543 F.2d 540, 542–43 (5th Cir.), *cert. denied,* 434 U.S. 824 (1977).

43. Byrd v. Dean Witter Reynolds, Inc., 726 F.2d 552 (9th Cir. 1984), *rev'd,* 105 S. Ct. 1238 (1985); *see also* Cunningham v. Dean Witter Reynolds, Inc., 550 F. Supp. 578, 585 (E.D. Cal. 1982).

44. 726 F.2d 552, 554 (9th Cir. 1984), *rev'd,* 105 S. Ct. 1238 (1985). The district courts in the Ninth

state and federal securities law violations. The investor-broker contract contained an arbitration agreement.[45] The broker moved to sever the pendent state claims and arbitrate them after litigation of the federal claims. The district court denied the motion.[46] On appeal, the Ninth Circuit held that, because the pendent state and federal claims depended on "substantially the same factual issues," the claims should be litigated together.[47] The court emphasized that the federal and pendent state claims should not be separated when the claims are so intertwined that the purposes of the Arbitration Act[48] and the protective intent of the federal securities law would be frustrated by separating the claims.[49] The Fifth and Eleventh Circuits also adopted the intertwining doctrine.[50]

Circuit were split on the issue of severance. Some district courts had adopted the bifurcated approach of trying the federal claim and staying arbitration of the state claim, *e.g.*, Roueche v. Merrill Lynch, Pierce Fenner & Smith, 554 F. Supp. 338 (D. Hawaii 1983); other district courts had adopted the intertwining doctrine, *e.g.*, Cunningham v. Dean Witter Reynolds, Inc., 550 F. Supp. 578 (E.D. Cal. 1982).

45. A common arbitration agreement is as follows:

> Any controversy between us arising out of or relating to this contract or the breach thereof, shall be settled by arbitration, in accordance with the rules, then obtaining, of either the Arbitration Committee of the Chamber of Commerce of _____, or the American Arbitration Association, or the Board of Arbitration of the New York Stock Exchange, as customer may elect . . . .

8A C. NICHOLS, CYCLOPEDIA OF LEGAL FORMS ANNOTATED § 8.5362, at 496 (1980).

46. *Byrd*, 726 F.2d at 553.

47. *Id.* at 554.

48. The Arbitration Act was designed to place arbitration agreements on the same footing as other contracts, and to promote fast and inexpensive dispute resolution. H.R. REP. NO. 96, 68th Cong., 1st Sess. 2 (1924).

49. 726 F.2d at 554.

50. The Ninth Circuit joined the Fifth and Eleventh Circuits when it adopted the intertwining doctrine. In Miley v. Oppenheimer & Co., 637 F.2d 318 (5th Cir. 1981), the Fifth Circuit held that the state and federal claims were so intertwined that the claims should be litigated. The *Miley* court reasoned that allowing an arbitrator to appraise the evidence and reach the primary conclusions on issues central to the resolution of the case would present a threat of binding the federal forum through collateral estoppel. *Id.* at 336–37. In Sawyer v. Raymond, James & Assocs., 642 F.2d 791 (5th Cir. 1981), the Fifth Circuit again upheld the intertwining doctrine. The court noted that factual severability of disputed claims was of central importance in determining whether claims should be subject to arbitration. *Id.* at 793.

The Eleventh Circuit adopted the intertwining doctrine in Raiford v. Buslease, Inc., 745 F.2d 1419 (11th Cir. 1984). The *Raiford* court reasoned that all intertwining claims should be litigated because of the threat of issue preclusion. *Id.* at 1423. The court emphasized that the possibility of preclusion might have the effect of encouraging parties to deliberately speed up or slow down one of the proceedings. The three circuits that adopted the intertwining doctrine concluded that collateral estoppel was the overriding concern in separating substantially similar claims. These circuits were secondarily concerned with the inefficiency of having two proceedings. This threat is probably more perceived than real, since a court is not forced to give collateral estoppel effect to arbitration findings in subsequent litigation. Surman v. Merrill Lynch, Pierce, Fenner & Smith, 733 F.2d 59 (8th Cir. 1984).

2. *Rejection of the Intertwining Doctrine*

Other courts rejected the intertwining doctrine, holding that state claims should be arbitrated.[51] These courts often stayed arbitration until the securities claims were resolved. Conversely, some courts stayed litigation pending arbitration. In favoring arbitration agreements, the courts stressed that an individual's right to contract should be upheld and that efficiency arguments were not sufficient to invalidate contractual provisions under the Arbitration Act.[52] In rejecting the intertwining doctrine, these courts held that the sequence of arbitration and litigation could be controlled to preserve exclusive federal jurisdiction.[53]

The Eighth Circuit rejected the intertwining doctrine in *Surman v. Merrill Lynch, Pierce Fenner & Smith.*[54] In *Surman,* investors brought an action alleging 10b-5 violations and common law fraud. The broker moved to compel arbitration pursuant to various arbitration agreements. The court rejected the intertwining doctrine and held that the state claims should be arbitrated.[55] The court concluded that, by staying arbitration until judicial resolution of the federal securities law claim, the court would not relinquish its exclusive jurisdiction.[56]

The *Surman* court cited the Ninth Circuit's decision in *Byrd* but expressly rejected its reasoning.[57] The court in *Surman* stated that neither the collateral estoppel argument nor the efficiency argument was sufficient to invalidate valid contractual provisions.[58] In rejecting the arguments advanced in favor of the intertwining doctrine, the *Surman* court relied on *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.,*[59] in which the Supreme Court reemphasized that the Arbitration Act is "a congressional declaration of a liberal federal policy favoring arbitration

51. *See supra* note 39 and accompanying text.

52. *See supra* note 22 and accompanying text.

53. *See, e.g.,* Dickinson v. Heinold Sec., Inc., 661 F.2d 638, 644 (7th Cir. 1981) (arbitration proceeding may be stayed pending litigation of federal securities claims); Applied Digital Technology, Inc. v. Continental Casualty Co., 576 F.2d 116, 117 (7th Cir. 1978) (arbitration of fraud claim may be stayed pending litigation of nonarbitrable antitrust claim).

54. 733 F.2d 59 (8th Cir. 1984).

55. *Id.* at 62.

56. *Id.* The court in *Surman* concluded that the concern over exclusive federal jurisdiction could be eliminated by controlling the timing of court and arbitration proceedings. *Id.* at 63. Thus, if the court stays the arbitration proceeding pending judicial resolution of the federal securities law claim, the court would not relinquish its exclusive authority. *Id.* at 62–63.

57. *Id.* at 62.

58. *Id.*

59. 460 U.S. 1 (1983).

agreements."[60] In *Moses*, the Court acknowledged that "piecemeal resolution" may be necessary to give effect to an arbitration agreement.[61] In addition to the Eighth Circuit, the Sixth[62] and Seventh Circuits[63] rejected the intertwining doctrine. Other circuits either had not addressed the issue,[64] or addressed it only indirectly.[65]

II. *DEAN WITTER REYNOLDS, INC. v. BYRD*

In *Dean Witter Reynolds, Inc. v. Byrd*,[66] the Supreme Court resolved the conflicting approaches of the appellate courts. The Court held that a district court must refer state claims to arbitration when they are joined with federal securities law claims.[67] The Court stated that neither a stay of arbitration nor joint proceedings was necessary to protect federal jurisdiction.[68] Citing the strong congressional desire to enforce contractual agreements between parties, it reasoned that arbitration of state claims is necessary to ensure that private agreements are judicially enforced.[69] In a footnote, the Court observed that the *Wilko* doctrine might not apply to section 10(b) claims but noted that the question was not before the Court.[70]

In a concurring opinion, Justice White criticized the application of the *Wilko* doctrine to section 10(b) claims. He explained that *Wilko* involved a claim under section 12(2) of the Securities Act, which gives rise to a private

60. *Id.* at 24. *Moses* involved a suit to compel arbitration of a dispute under a construction contract. The defendant opposed arbitration on the ground that only one of the two parties involved in the dispute was bound by the contract providing for arbitration. The defendant faced the prospect of having to resolve the dispute in two different forums. Nevertheless, the Court upheld arbitration.

61. *Id.* at 20.

62. Liskey v. Oppenheimer & Co., 717 F.2d 314 (6th Cir. 1983) (the plain language of the Arbitration Act required courts to stay the litigation of arbitrable state claims and refer them to arbitration). The *Liskey* court stated that much of the alleged inefficiency in bifurcated proceedings was "speculative and could be eliminated" but did not suggest any methods by which this might be accomplished. *Id.* at 320.

63. Dickinson v. Heinhold Sec., Inc., 661 F.2d 638 (7th Cir. 1981). The court refused to order litigation of both federal and state claims. It emphasized that duplication of effort was not sufficient to destroy the contractual right to arbitrate. *Id.* at 646. Furthermore, the Arbitration Act was specifically aimed at the historical problem of courts refusing to honor contractual arbitration agreements. The court feared that the intertwining doctrine would become the exception that swallowed the rule, allowing otherwise arbitrable claims to be litigated. *Id.* at 645–46.

64. This author found no cases in the Third or Fourth Circuits concerning the intertwining doctrine.

65. N. Donald & Co. v. American United Energy Corp., 746 F.2d 666 (10th Cir. 1984) (arbitration agreement between brokers). Since arbitration agreements are commonly enforced between brokers, this case is not an indication of the Tenth Circuit's view of the intertwining doctrine. *See also* Lee v. Ply*Gem Indus. Inc., 593 F.2d 1266 (D.C. Cir.) (rejected intertwining doctrine where arbitrable state claims joined with nonarbitrable federal antitrust claims), *cert. denied*, 441 U.S. 967 (1979).

66. 105 S. Ct. 1238 (1985).

67. *Id.* at 1244.

68. *Id.* at 1243.

69. *Id.* at 1242.

70. *Id.* at 1240 n.1.

cause of action.[71] In contrast, section 10(b) of the Exchange Act does not expressly provide a private cause of action.[72] Justice White found this distinction significant because, he reasoned, the provision of the Exchange Act which invalidates contrary stipulations does not apply to an implied right of action.[73] Moreover, he explained, *Wilko* stressed the "special rights" inherent in a section 12(2) action. A judicially implied cause of action such as section 10(b), however, is not worthy of "special rights" treatment.[74] Thus, Justice White would have ordered arbitration of both claims in *Byrd*.

III. ANALYSIS

The *Byrd* decision itself is unremarkable. Its significance lies in the Court's and Justice White's discussions of the potential inapplicability of *Wilko* to section 10(b) claims. The lower courts have consistently applied the *Wilko* doctrine to section 10(b) claims,[75] allowing litigation of such claims in federal court rather than referring them to arbitration. In view of the *Byrd* Court's observation that the question is an open one, and considering the trend of the Supreme Court to limit the scope of the Securities Acts,[76] the Court may eventually hold that *Wilko* does not apply to section 10(b) claims.

If the Court holds that *Wilko* does not apply to section 10(b) claims, an anomalous situation would result. When section 12(2) claims are joined with section 10(b) claims, the former would be litigated while the latter would be arbitrated. This procedure would serve neither the goals of the securities acts nor those of the Arbitration Act. A better solution is for Congress or the Court to improve the arbitration process and then to allow arbitration of all federal securities claims, whether brought under sections 10(b), 12(2), or any other section of either Act.

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71. *Id.* at 1244 (White, J., concurring).

72. The Supreme Court implied a cause of action in J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

73. Dean Witter Reynolds, Inc. v. Byrd, 105 S. Ct. at 1244 (White, J., concurring). Justice White's distinction may be less significant in light of Eichler v. Berner, 105 S. Ct. 2622 (1985) (Court did not consider the distinction between implied right and express right of action in determining the availability of the *in pari delicto* defense).

74. 105 S. Ct. 1244 (1985) (White, J., concurring).

75. *See, e.g.*, Sibley v. Tandy Corp., 543 F.2d 540 (5th Cir. 1976), *cert. denied*, 434 U.S. 824 (1977).

76. *See, e.g.*, Dirks v. SEC, 463 U.S. 646 (1983); Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

A. The Argument For Arbitration

Arbitration can have several advantages for investors if certain changes are made in the arbitration process. If arbitration procedures are fair, and if investors have adequate notice of the rights they are waiving by signing an arbitration agreement, then investors should be held to that agreement.

1. The Arbitration Process

The arbitration process is relatively simple.[77] First, the investor must choose among the various self-regulatory associations that can arbitrate the dispute. Next, the investor must file a claim letter with the associations' director of arbitration setting forth the details of the dispute. The investor must sign an agreement to submit the dispute to arbitration and remit a fee for arbitration.

After the demand for arbitration is served on the opposing side, the arbitrators must be appointed. The director of arbitration determines who shall serve on the arbitration panel and names the chairperson of the panel.[78] The investor has one peremptory challenge and an unlimited number of challenges for cause.[79]

The director decides where and when the hearing will be held, but the investor may request a certain locale.[80] The arbitration proceeding itself is conducted much like a trial, with an opening statement, presentation of the case by an attorney or the investor, and closing statements. After the arbitrators have reached their decision, copies of the award are mailed to the parties.[81]

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77. *See* SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, UNIFORM CODE OF ARBITRATION (1977) [hereinafter cited as UNIFORM CODE], *reprinted in* NATIONAL ASS'N OF SEC. DEALERS, CODE OF ARBITRATION PROCEDURE 4–14 (1984). The Securities Industry Conference on Arbitration (S.I.C.A.) has adopted the UNIFORM CODE. Katsoris, *supra* note 2, at 283–84. The S.I.C.A. consists of representatives from various self-regulatory securities organizations, a securities industry trade association, and the public. During 1979 and 1980, the UNIFORM CODE was adopted by the American, Boston, Cincinnati, Midwest, New York, Pacific, and Philadelphia Stock Exchanges, the Chicago Board of Options Exchange, the Municipal Securities Rulemaking Board, and the National Association of Securities Dealers. Katsoris, *supra* note 2, at 283. The investor who arbitrates must choose among several forums established by the self-regulated securities associations, such as the National Association of Securities Dealers. Fees for arbitration range from $15 for a claim of $1000 or less, to $750 for a claim exceeding $100,000.

78. UNIFORM CODE, *supra* note 77, at § 20.

79. *Id.* § 22.

80. *Id.* § 26.

81. *Id.* § 41.

2. *Advantages of Arbitration for the Investor*

The significant advantage of arbitration for the investor is that it is a relatively inexpensive and speedy process.[82] Securities investors need a forum in which disputes can be resolved quickly because delay in adequate resolution can result in exposure to market risk.[83] Moreover, because arbitration is less formal and complex than court proceedings, investors can more easily represent themselves. The discovery process in arbitration is also less involved. Investors may obtain information without the formalities of depositions and interrogatories.

As long as arbitration is fair, and investors have notice of which rights they are waiving when they sign an arbitration agreement, there is no reason to ignore a contractual arrangement to arbitrate. Because substantive rights could be lost or unknowingly waived, however, some commentators have questioned the desirability of arbitration as a forum for resolving securities fraud disputes.[84] There are plausible arguments in favor of litigating federal claims, but arbitration, once modified, can answer the concerns raised in these arguments.

Courts and commentators have expressed four main concerns with the present arbitration system. First, the investor gives up the right to a jury trial by submitting claims to arbitration.[85] If, however, the investor knows and understands the implications of waiving the right to a jury trial, and if the arbitration election is optional, the broker's contractual right should be recognized and the claims arbitrated.

The second area involves procedural concerns. An investor receives the benefits of nationwide service of process by litigating in federal court; the investor can serve the broker anywhere.[86] The investor does not lose this advantage, however, in bringing an arbitration action. All the investor need do is file a claim with the director of arbitration and it is sent to the opposing party.[87] In federal court, a particular venue is usually selected because it is more convenient for one of the parties. In an arbitration proceeding, while the investor may request a certain locale, the director of arbitration determines the location of the hearing. This area of arbitration could be improved by providing guidelines for choosing the location of arbitration, or

82. *See supra* note 11.

83. Krause, *supra* note 15, at 721. An investor's securities portfolio can decline substantially in value if the market turns downward between the time that the claim arose and resolution of that claim.

84. *See, e.g.*, Comment, *supra* note 1, at 129–33.

85. The right to a jury trial in federal court is provided in the seventh amendment. U.S. CONST. amend. VII. Thus, when securities claims are litigated in federal court, the investor has the right to request a jury trial.

86. *See supra* note 35.

87. *See* UNIFORM CODE, *supra* note 77, at § 25. The opposing party has 20 business days to provide an answer.

by requiring that the proceedings be held in the city closest to the investor's residence.[88]

Third, securities claims have been compared to antitrust claims; it has been argued that since antitrust claims cannot be arbitrated, securities claims should not be arbitrated.[89] The policy of resolving antitrust issues in the public forum, however, may not apply to investor-broker disputes.[90]

Finally, a major complaint against arbitration is lack of adequate discovery. The Uniform Code of Arbitration[91] provides for a subpoena process if the parties are unable to obtain access to witnesses or documents.[92] Arbitration is faster and less expensive than litigation, in part because discovery is limited. If the full range of discovery rights available under the Federal Rules of Civil Procedure were allowed in arbitration, the process would take longer and be more expensive to investors.[93] Rather than increasing the time and expense of arbitration, the limited discovery available in arbitration should be clarified so that investors can obtain adequate information to present their claims.

B. A New Rule Allowing Arbitration of Federal Securities Claims

Arbitration proceedings can be beneficial to investors, provided investors have adequate notice of the rights that they are waiving. Nevertheless, arbitration of federal claims conflicts with the language of the Securities Act[94] as interpreted in *Wilko*.[95] The *Wilko* Court had three reasons for holding that federal securities claims are nonarbitrable. First, the Court was concerned about inequality of bargaining power and stressed that the Securities Act contains an express policy of protecting the investor.[96] Second, the Court relied on the language from the Securities Acts prohibiting contrary stipulations.[97] Third, the Court expressed reservations about the adequacy of arbitration because the investor loses the advantages of

88. *See supra* text accompanying note 80.

89. *See, e.g.*, Allegaert v. Perot, 548 F.2d 432, 436 (2d Cir.), *cert. denied*, 432 U.S. 910 (1970).

90. One policy for not allowing arbitration of antitrust claims is that the complex legal and factual issues are more appropriate for judicial consideration. *Allegaert*, 548 F.2d at 437. However, most investor disputes involve section 10b-5 claims, which present issues substantially similar to common law fraud and are not typically factually complex. Krause, *supra* note 15, at 707.

91. *See* UNIFORM CODE, *supra* note 77.

92. *Id.* § 32.

93. Neville, *The Enforcement of Arbitration Clauses in Investor-Broker Agreements*, 34 ARB. J. 5, 10–11 (1979).

94. Wilko v. Swan, 346 U.S. 427, 438 (1953).

95. *See supra* text accompanying notes 24–33.

96. *Wilko*, 346 U.S. at 430–31.

97. *Id.* at 435.

litigation in federal court.[98] The Court suggested that when arbitration agreements are signed, the investor may be unable to "judge the weight of the handicap the Securities Act places upon his adversary."[99] The *Wilko* doctrine might be changed by congressional action. Any change, however, should address the concerns raised by the *Wilko* Court.

1. Congressional Action: Changing the Wilko *Doctrine*

Congress could amend the securities acts to allow for arbitration agreements. This could best be done by adding a clause of exception to the section prohibiting contrary stipulations.[100] To address the *Wilko* Court's concerns about inequality of bargaining power and investor protection,[101] Congress could require that arbitration clauses be "clear and conspicuous" in warning that the investor is surrendering certain rights, specifically, the right to a jury trial in federal court.

Once Congress has amended the securities acts to allow arbitration, the SEC should promulgate rules requiring that conspicuous legends and warnings be placed on arbitration agreements.[102] Such regulations might

98. *Id.* Two disadvantages discussed by the Court were that arbitrators are allowed to make judgments without explaining their reasoning or providing a record of the proceeding and that the judicial power to vacate an award is limited. *Id.* at 435–37.

99. *Id.* at 435.

100. Section 29(a) of the Exchange Act provides an example of the nonwaiver provisions: "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this title or of the rules and regulations or commission shall be void." 15 U.S.C. § 78cc(a) (1982).

An example of a clause of exception is: "Except that this provision shall not apply to qualified arbitration agreements." Qualified arbitration agreements should be defined as those agreements complying with relevant SEC rules and association guidelines.

101. This inequality of bargaining power stems from the fact that securities sellers regularly enter into securities agreements, whereas buyers less frequently engage in securities transactions and hence may not be aware of or understand the implications of the arbitration clause.

102. The SEC has been critical of arbitration agreements forced upon customers without adequate disclosure of the investor's rights. Securities Exchange Act Release No. 15,984, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,122, 81,976–78 (July 2, 1979). The SEC was concerned that investors may be unaware of their right to litigate their federal securities claims in federal court. *Id.* at ¶ 81,975. Because of that concern, the SEC stated that brokers should include information in arbitration clauses concerning investors' rights to a federal forum, so that such clauses are not misleading. *Id.*

After the SEC voiced its concern about arbitration clauses, the S.I.C.A. added the following introductory statement to its booklet for investors involved in arbitration:

> The Supreme Court, in the case of Wilco [sic] vs. Swan, . . . and other federal courts have held that a customer of a broker-dealer could not be compelled to arbitrate a claim arising under certain federal securities acts, even though the customer had signed an agreement with the broker-dealer to arbitrate future controversies. If you have signed such a pre-dispute arbitration agreement, you may wish to consult with counsel before proceeding with arbitration.

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require that the warning be in boldface type, analogous to the conspicuous language requirement in a products liability statute for warranty disclaimers.[103] The SEC might also require that a specific legend must appear in all such agreements. This could be similar to the legends required in certain prospectuses under the Securities Act of 1933.[104] Finally, the regulations could require that the arbitration agreement be on separate paper so that the investor's attention is adequately drawn to the rights surrendered. Following promulgation of these rules, the various securities regulatory organizations, such as the National Association of Securities Dealers (NASD), could communicate the regulations to brokers and dealers and urge compliance with those regulations.[105]

2. *Judicial Action*

Congressional amendment of the securities acts to allow arbitration is preferable to judicial modification of the *Wilko* doctrine because Congress can best require compliance with detailed disclosure rules. Despite repeated calls for reform,[106] Congress has been slow to amend the fifty-year-old securities acts. Consequently, the judiciary might modify the *Wilko*

(1984). The SEC and the S.I.C.A. have sought to make arbitration provisions more fair. The self-regulated securities industry, however, has the ultimate responsibility for ensuring that investors are aware of their rights under arbitration agreements. *See also* Katsoris, *supra* note 2, at 296.

In order to further spur brokers toward making arbitration agreement disclosures, the SEC adopted Rule 15c2-2 in 1983. 3 FED. SEC. L. REP. (CCH) ¶ 26,916, at 20,173-2 (1983). Rule 15c2-2 provides, in part: "It shall be a fraudulent, manipulative or deceptive act or practice for a broker or dealer to enter into an agreement with any public customer which purports to bind the customer to the arbitration of future disputes between them arising under the Federal securities laws . . . ." 17 C.F.R. § 240.15c2-2(a) (1985).

If the forum for resolution of investor disputes is moved from the courts to the self-regulatory associations, the SEC must continue to oversee closely the activities of such associations. In turn, the self-regulatory organizations must maintain high standards in policing members.

103. *See, e.g.*, U.C.C. § 2-316 (1977).

104. *See,* Regulation D, 12 C.F.R. § 230.502 (D)(d)(3)(1985).

105. There are two main sections of the Exchange Act that regulate the registration of securities exchanges and national associations. Section 6(b) of the Exchange Act authorizes exchanges to register as self-regulatory entities and requires that exchanges promulgate rules promoting "just and equitable principles of trade" and provide for discipline of members engaging in "fraudulent and manipulative acts and practices." 15 U.S.C. § 78f(b)(5) (1982). Section 15A(b)(8) of the Exchange Act provides for the establishment of national securities associations to supervise the securities markets. In order for a group of brokers and dealers to form an association, the group must file an application for registration with the SEC that contains the rules of the association. *See* 15 U.S.C. § 78o-3(a)(1982).

The National Association of Securities Dealers (NASD) filed its registration statement with the SEC on July 20, 1939. NATIONAL ASS'N OF SEC. DEALERS, REPRINT OF THE NASD MANUAL 109–10 (1985). The NASD Board of Governors determines policy and sets up committees to study problems and suggest actions to be taken. The SEC can review any disciplinary action imposed by a broker-dealer association, promulgate superseding regulations or revoke any association's registration if the association does not enforce compliance with its own rules. *See* 15 U.S.C. §§ 78s(c), (d) (1982).

106. Krause, *supra* note 15, at 720.

doctrine without congressional action. Again, any judicial modification to allow for arbitration of federal claims must address the *Wilko* Court's concerns.

Courts could address the concern of inequality of bargaining power by requiring proof that an arbitration agreement was freely negotiated before giving effect to the agreement. Once courts are convinced that arbitration provisions are freely agreed to by informed investors, the gap in bargaining power between investors and brokers would be greatly narrowed. The courts could then interpret arbitration provisions as fair agreements, rather than as waivers of important substantive rights. With respect to investor protection, the courts could inquire into other grounds of invalidating arbitration agreements, such as unconscionability.[107] These claims would fall under the provision for revocation of arbitration agreements as set forth in the Act.[108]

The *Wilko* Court argued that the provisions of the 1933 Act cannot be waived by contrary stipulations.[109] In order to circumvent this provision for section 12(2) claims, the Court would have to overrule *Wilko* and hold that in the contrary stipulations section, Congress intended only to include such contrary stipulations as one stating that the purchaser is a knowledgeable investor and will not hold the seller liable for misrepresentations. With regard to section 10(b) claims, the Court could hold, as Justice White argued in *Byrd*, that the contrary stipulations section may have no meaning with respect to implied rights of action under section 10(b).[110] The Exchange Act does, however, provide for exclusive jurisdiction in federal court.[111] Thus, the Court would have to resolve this issue in overruling *Wilko*. Since the Securities Act provides for concurrent jurisdiction[112] in state and federal courts, exclusive jurisdiction is not a problem with respect to 12(2) claims.

3. *Industry Improvements in Securities Arbitration*

Additional concerns of the *Wilko* Court were the competency of arbitrators and the fairness of the proceedings.[113] Major improvements must

107. *See, e.g.*, Pierson v. Dean Witter Reynolds, Inc., FED. SEC. L. REP. (CCH) ¶ 91,615 (7th Cir. Aug. 6, 1984) (plaintiffs unsuccessfully argued that arbitration clause was unconscionable as a contract of adhesion).

108. *See supra* note 16.

109. *See supra* text accompanying notes 29–30.

110. 105 S. Ct. at 1244 (White, J., concurring). The exclusive jurisdiction provision of the 1934 Act also may not apply to jurisdiction over implied causes of action. *Id.*

111. 15 U.S.C. § 78aa.

112. 15 U.S.C. § 77v.

113. Wilko v. Swan, 346 U.S. 427, 436 (1953).

be made in the arbitration process in order to answer these concerns. These are changes that the Court could only suggest, but could not implement. The SEC and the industry itself must implement these changes.

Arbitration of both federal and state claims, although arguably preferred, presents some disadvantages for the investor. There are two key areas of arbitration proceedings that require improvement. First, as discussed earlier, investors who arbitrate surrender important discovery rights. Investors may be unable to learn about the number of commissions generated by their account or the nature of recommendations made by the broker.[114] The regulatory associations should ensure that the discovery process is sufficient for investors to present their claims.

Another area that needs improvement is investor perception of the fairness of the arbitration process. It is important to create investor confidence in arbitration. This confidence will come from demonstrating that arbitration procedures are fair.[115] One obvious barrier to confidence in arbitration is the common requirement that investors submit disputes to arbitrators who are selected by the self-regulated securities industry.[116] Unless a public customer elects otherwise, the majority of the arbitration panel will be persons from outside the securities industry.[117] These outside individuals, however, are often attorneys who represent brokers. Investors might have more confidence in the fairness of arbitration procedures if the arbitration panel had representation from other professions.

Fairness would also be enhanced if arbitrators were required to state reasons with their awards. Without published findings of fact, arbitration will continue to be criticized as a haphazard process. With publication of reasons, parties would have access to a body of arbitral law and thus know better what to expect from arbitration.

If Congress amends the securities acts to allow arbitration, or in the alternative, if the Court overrules *Wilko* to allow arbitration of all securities claims, the SEC should promulgate rules that ensure fair arbitration proceedings. The NASD and other regulatory associations should then issue guidelines to member broker-dealers regarding the use of arbitration clauses. These guidelines should set forth sanctions for noncompliance including the discipline of brokers and the revocation of licenses.

114. Comment, *supra* note 1, at 131.
115. *Id.* at 123.
116. Krause, *supra* note 15, at 720.
117. *See* UNIFORM CODE, *supra* note 77, at § 9.

IV. CONCLUSION

In *Dean Witter Reynolds, Inc. v. Byrd,* the Supreme Court hinted that section 10(b) claims may not be subject to the *Wilko* nonarbitration doctrine. This leaves open the possibility that at least some federal claims may be arbitrated in the future. While Congress might amend the securities acts to allow arbitration of federal claims, such action is not imminent. The Supreme Court clearly has the power and the opportunity to overrule *Wilko*. It should refrain from doing so, however, until the arbitration process has been substantially improved. To that end, the securities industry must take its mandate of self-regulation seriously and work to make arbitration proceedings more consistent with the policy of investor protection.

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