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## United States Senate

COMMITTEE ON THE JUDICIARY

WASHINGTON, DC 20510-6275

BRUCE A. COHEN, *Chief Counsel and Staff Director*  
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May 4, 2007

The Honorable Christopher Cox  
Chairman  
United States Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

Dear Chairman Cox:

We write regarding the prevalence of mandatory arbitration clauses in securities brokerage contracts. While arbitration can offer investors a valuable alternative to the courts as a means of resolving disputes, the increasing trend of stronger parties to a contract forcing weaker parties to waive their rights to judicial process is reason for serious concern. Although the Securities and Exchange Commission ("SEC") has done a good job regulating some other aspects of securities arbitration, we are troubled that the SEC has not adequately addressed the problem of mandatory arbitration clauses.

When Congress enacted the Securities Act of 1933 and the Securities Exchange Act of 1934, it provided investors with an enhanced judicial remedy intended to serve as the foundation for vigorous private enforcement of the Acts' new comprehensive protections. The threat of public prosecution by individual investor-litigants gave teeth to the enforcement of securities laws, and Congress intended that this special judicial remedy be widely available to investors. Because securities firms today almost uniformly present prospective customers with contracts that include "take-it-or-leave-it" mandatory arbitration clauses, most investors are no longer able to invoke the courts to assert their rights either under the Acts or state laws. Accordingly, we request that the SEC, in fulfillment of its statutory duty to protect individual investors, promulgate a rule that will prohibit broker-dealers from requiring investors to accept mandatory arbitration clauses.

In its 2000 *Report on Securities Arbitration* (GAO/GGD-00-115), the General Accounting Office noted that the number of securities cases processed in the courts was "too small to make meaningful comparisons" to those processed through arbitration and later explained that all nine of the largest twelve brokerage firms that replied to its survey "require individual investors to agree to resolve their disputes through SRO-sponsored arbitration as a condition of opening most types of accounts." *Id.* at 5, 30. Since then, this situation has only worsened. On its own website, the SEC tacitly recognizes that the

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judicial remedy has been virtually extinguished for investors when it states: “[I]f you have a brokerage account, you probably signed an agreement that requires you to settle any disputes with your broker through arbitration rather than the courts.”

Where investors face a stark choice between signing a mandatory arbitration agreement and forgoing investment-related services, we cannot say honestly that arbitration has been voluntarily selected. Instead, we must admit that arbitration has been imposed on investors—regardless of their wishes—by the brokers, which hold much greater bargaining power. In the SEC Office of Inspector General’s (“OIG”) 1999 audit titled *Oversight of Self-Regulatory Arbitration*, the OIG conceded that “to the extent investors are unable to open accounts without signing mandatory arbitration agreements, they perceive that their participation in securities arbitration is involuntary.” *Id.* at 4.

Thus far, the SEC has not responded to this specific problem with regulations. Instead, the Commission has declined to act beyond imposing stricter disclosure requirements, explaining that so long as the terms of any contract were fully disclosed, further regulation was unnecessary. *Id.* at 5. This policy may have been sufficient in the past when investors could, through their own initiative, identify and select brokers that did not include mandatory arbitration clauses in their standard contracts. With the prevalence of such clauses in today’s brokerage contracts, however, the Commission must step in on behalf of the individual investors and restore their ability to choose judicial process.

The SEC’s mission is, first and foremost, to protect investors, and simply relying on investors’ ability to exercise informed choice when no choice is actually offered is clearly insufficient. Arbitration can be a fair and efficient way to settle disputes, but only when it is entered into knowingly and voluntarily by both parties to the dispute. We call on the Commission to consider the best mechanisms to address this problem, giving particular attention to the following alternatives: (1) a rule banning all pre-dispute mandatory arbitration clauses; or (2) if pre-dispute agreements are to be allowed, a rule requiring broker-dealers to provide their customers with a “check-the-box” choice between traditional judicial process and Self-Regulatory Organization (“SRO”) arbitration.

Two Supreme Court cases from the 1980s, *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987), and *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989), paved the way for the expansive judicial enforcement of mandatory arbitration clauses under the Securities Acts. In both cases, the assumptions and rationale underlying the Supreme Court’s rulings are clear: that arbitration increases rather than limits options and that the SEC will actively monitor arbitration to ensure it offers adequate investor protections. Promulgation of either of the aforementioned rules would be consistent with the Supreme Court’s rulings on this issue.

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First, arbitration agreements were presumed by the Court to “advance the objective of allowing buyers of securities a *broader* right to *select* the forum for resolving disputes.” *Rodriguez de Quijas* at 483 (emphasis added). This rationale that arbitration is valid on the grounds that it broadens the choices for claimants to select their forum is echoed in decisions upholding arbitration agreements in other contexts. *See, e.g., Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 29 (1991). When the Supreme Court decided *McMahon* and *Rodriguez de Quijas*, it was not standard practice across the brokerage industry to include mandatory arbitration clauses in customer contracts, and many investors were free to select among brokers on the basis of whether they did or did not permit judicial process. That mandatory arbitration clauses are now an industry norm—and thus a *de facto* requirement imposed upon investors—is a significant shift from one of the presumptions essential to the Court’s decisions. The SEC should act to require that brokers allow investors to have an actual choice between the courts and arbitration, thereby restoring the element of voluntariness assumed by the Court.

Second, the SEC was presumed by the Court to be exercising its “authority to oversee and to regulate those arbitration procedures.” *Rodriguez de Quijas* at 483. As noted in *McMahon*, the Commission has “expansive power” to regulate in this area. *Id.* at 233. Thus, issuing an appropriate rule is consistent with the second presumption of the Court as well. In an amicus brief filed by the SEC in the 2002 case, *NASD Dispute Resolution, Inc. and New York Stock Exchange, Inc., v. Judicial Council of California, et al*, the Commission correctly asserted that it “has full supervisory authority over the rules adopted by SROs, including the power to mandate the adoption of additional rules.” Indeed, this power has been both contemplated and exercised with regard to mandatory arbitration clauses in the past. *See, e.g.,* Current Rule 10301(d) of NASD Code of Arbitration. It is the SEC’s charge to protect the interests of the American investor and to regulate in furtherance of this duty. Promulgation of a rule concerning mandatory arbitration is clearly within the power of the Commission and is consistent with its charter.

Investors must have the opportunity to meaningfully weigh arbitration’s benefits against a set of significant trade-offs. Notwithstanding the SEC’s efforts to ameliorate some of the most troubling aspects of arbitration, agreeing to arbitration is still a waiver of constitutional rights that are protected in the judicial system. For instance, arbitration (1) lacks the formal court-supervised discovery process often necessary to learn facts and gain documents; (2) does not require that arbitrators follow the rules of evidence laid out for state and federal courts; (3) imposes no obligation on arbitrators to provide factual or legal discussion of the decision in a written opinion; and (4) severely limits judicial review. Arbitration is structured to create a more streamlined proceeding in order to provide faster and less expensive decisions, though at the cost of reduced legal certainty.

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The appeal of arbitration and mediation for disputes that are relatively straightforward or that involve modest damages will ensure that such alternative dispute resolution processes can continue to be the primary means for resolving disputes even after implementation of a rule that is more protective of investors. At the same time, restoring investors' access to the courts would enable some investors to assert their rights more effectively than in arbitration. Thus, an investor who requires significant discovery to show that she was the victim of coordinated misconduct by a firm will be much better able to substantiate this kind of complex claim with the more extensive discovery procedures of state or federal court. Although citizens are permitted to waive certain constitutional rights, it is important to remember that implicit in the constitutional foundation of our civil justice system is the basic principle that individuals should not be coerced or misled into waiving such fundamental rights.

SEC promulgation of either of the mandatory arbitration rules suggested above would not indicate any disapproval of arbitration, nor would it lessen the benefits that arbitration can bring to the securities field. Rather, by insisting on the element of voluntary participation in the arbitration process, the SEC would strengthen the validity of arbitration as a forum for resolving disputes. According to the SEC's Office of Inspector General, "virtually all of the officials" surveyed by OIG during the audit believed that even if the SEC were to eliminate mandatory arbitration agreements altogether, the more sweeping of the two proposals we have made, such regulation would not result in a significant decrease in the number of disputes handled through arbitration. *Oversight of Self-Regulatory Arbitration* at 4. The OIG continued that if—instead of being bound by mandatory arbitration agreements—investors were given the *choice*, those investors "would perceive the securities arbitration process more favorably." *Id.*

We believe we should encourage arbitration and mediation in cases where they can be helpful. Should the SEC act as suggested in this letter, the quality of the securities arbitration process will be improved. As the SEC's Division of Market Regulation stated when it recommended in 1988 that brokers be prohibited from requiring mandatory arbitration clauses, reintroducing the element of competition between SROs and the courts for the investor dispute resolution business "should increase incentives to SROs and their members to ensure that the arbitration forum remains fair and efficient." *Id.* at 5. Arbitration will remain as a vital option for investors; at the same time, in those circumstances where an investor with a complex or particularly sensitive claim might be better protected by traditional judicial process, the SEC will have ensured that that protection is available.

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One of the most important pillars of our justice system, enshrined in the Seventh Amendment, is the right to take a dispute to court. Crowded court dockets and the expense of litigation lead many litigants in civil cases appropriately to seek alternative ways to resolve their disputes. It may well be that arbitration is the best way of resolving many of these matters and that most investors, when given the choice, will select arbitration. It is vital, however, for the SEC to ensure that American investors are given a meaningful opportunity to make the choice between arbitration and traditional judicial process. There can be no doubt that investors would be better off with a choice between the court remedy provided by Congress and SRO arbitration than they are currently with no option but SRO arbitration.

Thank you for your attention to this important matter. We look forward to your response.

Sincerely,



RUSSELL D. FEINGOLD  
United States Senator



PATRICK LEAHY  
Chairman