The Arbitration of Securities Law Disputes After Rodriguez and the Impact on Investor Protection

Janet E. Kerr

Follow this and additional works at: http://scholarship.law.marquette.edu/mulr

Part of the Law Commons

Repository Citation
Available at: http://scholarship.law.marquette.edu/mulr/vol73/iss2/2
THE ARBITRATION OF SECURITIES LAW
DISPUTES AFTER RODRIGUEZ AND
THE IMPACT ON INVESTOR
PROTECTION

JANET E. KERR

I. INTRODUCTION

In *Rodriguez de Quijas v. Shearson/American Express*, the United States Supreme Court struck a final blow to *Wilko v. Swan*, a decision rendered thirty-five years ago. *Wilko* held that predispute arbitration agreements between brokers and their clients were unenforceable when an investor brought a claim under subsection 12(2) of the Securities Act of 1933 [hereinafter “Securities Act”]. *Wilko* ruled that the resolution of such a claim in a judicial forum could not be waived. In reversing *Wilko*, the

3. Subsection 12(2) provides:

   Any person who . . .

   (2) 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 such security from him, who may sue either at law or in equity in any court of competent jurisdiction . . . .

5. Id. at 435.
Rodriguez Court has literally opened up the flood gates for the arbitration of federal securities laws claims.6

This article analyzes the reasons for the change in the Court’s position and attempts to focus on the problems and inconsistencies created by the Rodriguez decision, as well as the issues left unaddressed by the case. In doing so, it is necessary to discuss the clash between the underlying policies of the federal securities laws and those of the Federal Arbitration Act7 and to examine the Supreme Court cases preceding Rodriguez which have dealt with this conflict.8

II. THE FEDERAL SECURITIES LAWS AND THE FEDERAL ARBITRATION ACT — THE PURPOSES OF EACH AND THE RESULTING CONFLICT

The Stock Market Crash of 1929 led to the passage of the Securities Act9 as well as the Securities Exchange Act of 1934 [hereinafter “Exchange Act”].10 Both were passed to protect investors from the same kind of problems that caused the Crash, namely fraud and the lack of information surrounding securities transactions.11

6. The number of securities disputes over the past six years has grown steadily. It appears that this trend can be attributed to the Supreme Court’s decision in Shearson/American Express v. McMahon, 482 U.S. 220 (1987), which prohibited the waiver of arbitration clauses in actions commenced under subsection 10(b) of the Securities and Exchange Act of 1934. It is anticipated that Rodriguez will do the same. For example, through August 1988, the New York Stock Exchange [hereinafter “NYSE”] caseload increased 91% over the comparable 1987 period. The caseload has increased “geometrically” and has been felt by all Self-regulating Organizations [hereinafter “SROs”]. See Morris, Securities Arbitration After McMahon: An SRO Perspective, PLI CONFERENCE REPORT 759, 762, 769 (Sept. 12, 1988).


11. United States v. Naftalin, 441 U.S. 768, 775 (1979). In Naftalin, the Supreme Court stated that Congress’ primary intent in passing the Securities Act was to prevent fraud against investors and to heal the economy. Id. The Exchange Act was also passed to further these objectives. See Note, Mixed Arbitrable and Nonarbitrable Claims in Securities Litigation: Dean Witter Reynolds, Inc. v. Byrd, 34 CATH. U.L. REV. 525, 533 n.52 (1985). It was thought that the une-
The Securities Act was passed to prevent fraud and the lack of information in the initial offer or sale of securities.\textsuperscript{12} It was also enacted to provide investors with express rights of action as delineated in subsection 12(2).\textsuperscript{13} The Exchange Act was passed with these same purposes in mind; however, the Exchange Act regulates the trading of securities in the secondary market, the exchanges and over-the-counter markets. Additionally, it serves to prevent fraud and manipulation in these markets.\textsuperscript{14} Unlike the Securities Act, the Exchange Act has no similar express private cause of action similar to subsection 12(2).\textsuperscript{15} Rather, it contains subsection 10(b),\textsuperscript{16} a general

---

\textsuperscript{12} Naftalin, 441 U.S. at 775-76.

\textsuperscript{13} Section 12(2) is one of the provisions of the Securities Act that offers a purchaser an express cause of action against persons who have made false or misleading statements or omissions in connection with the offer or sale of a security. \textit{See supra} note 3. Section 12(2) attempts to equalize the unequal bargaining power that exists between securities industry personnel and their customers by requiring full disclosure of material information to buyers of securities. \textit{See Malcolm & Segall, supra} note 8, at 730-31.

\textsuperscript{14} \textsuperscript{14} \textit{See} Note, \textit{supra} note 11, at 531-34.

\textsuperscript{15} \textsuperscript{15} \textit{See} Malcolm & Segall, \textit{supra} note 8, at 732.

\textsuperscript{16} Section 10(b) of the Exchange Act states:

\begin{quote}
\begin{itemize}
\item It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . .
\item (b) \textit{To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.}
\end{itemize}
\end{quote}


Pursuant to this authority, the Securities Exchange Commission [hereinafter “SEC”] promulgated Rule 10(b)-5, which provides:

\begin{quote}
\begin{itemize}
\item It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange-
\item (a) \textit{To employ any device, scheme, or artifice to defraud,}
\item (b) \textit{To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or}
\item (c) \textit{To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.}
\end{itemize}
\end{quote}

\textsuperscript{17} C.F.R. § 240.10(b)-5 (1989).
antifraud provision,\textsuperscript{17} which is a judicially implied private cause of action.\textsuperscript{18} Both federal securities laws also provide specifically for the manner in which disputes are to be decided. They each require a judicial forum. The Securities Act empowers federal and state courts with concurrent jurisdiction.\textsuperscript{19} The Exchange Act, on the other hand, empowers the federal courts with exclusive jurisdiction.\textsuperscript{20}

The Federal Arbitration Act [hereinafter "Arbitration Act"] was passed in 1925,\textsuperscript{21} prior to the passage of both securities acts, and established a "federal policy favoring arbitration."\textsuperscript{22} The Arbitration Act was passed to promote the use of arbitration as an alternative to litigation as well as to overcome judicial hostility toward arbitration.\textsuperscript{23} It was felt that an efficient

\begin{enumerate}
\item[17.] Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976) (referring to subsection 10(b) as a "'catchall' clause").
\item[18.] See Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983) (stating that a private cause of action, under both subsection 10(b) of the Exchange Act and Rule 10b-5, has been consistently recognized and that "[t]he existence of this implied remedy is simply beyond peradventure").
\item[19.] Subsection 22(a) of the Securities Act creates concurrent federal state jurisdiction of all Securities Act claims. It provides:

\begin{quote}
The district courts of the United States and the United States courts of any Territory, shall have jurisdiction of offenses and violations under this subchapter and under the rules and regulations promulgated by the Commission in respect thereto, and, concurrent with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by this subchapter. Any such suit or action may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took place, if the defendant participated therein, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. . . . No case arising under this subchapter and brought in any State court of competent jurisdiction shall be removed to any court of the United States.
\end{quote}

\item[20.] Section 27 of the Exchange Act creates exclusive federal jurisdiction and provides:

\begin{quote}
"The district courts of the United States . . . shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder." 15 U.S.C. § 78aa (1988).
\end{quote}

\item[22.] Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp., 460 U.S. 1 (1983). The Court stated:

\begin{quote}
The Arbitration Act establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability.
\end{quote}

and relatively low-cost process of adjudicating business disputes was needed. The Arbitration Act provides that arbitration agreements shall be enforced to the same degree as other contractual agreements. Additionally, there is a presumption in favor of arbitrating disputes unless an exception or defense can be found under the Arbitration Act or the Act is overridden by contrary congressional intent.

Once a judicial action is commenced between parties to an arbitration agreement, the Arbitration Act requires both federal and state courts to stay judicial proceedings in favor of arbitration upon request of either party. The Arbitration Act also provides that if one party wishes to invoke a predispute arbitration provision before filing a complaint, but the opposing party refuses to comply, the first party may unilaterally petition a United States district court for an order compelling arbitration.

III. THE MANY FACES OF WILKO V. SWAN — WILKO AND ITS INTERPRETATIONS

From the moment the Court rendered its decision in Wilko v. Swan, confusion and contradicting interpretations of the case followed. Most of the uncertainty was provided by the Court itself in its post-Wilko decisions. In order to reach an understanding of the Court's recent holding in Rodri-

---

26. The most common defenses are fraud or overreaching. See infra note 267 and accompanying text.
27. McMahon, 482 U.S. at 226. The Court stated that the burden was on the party opposing arbitration to prove congressional intent “deducible from [the statute's] text or legislative history ... or from an inherent conflict between arbitration and the statute's underlying purposes.” Id. at 227 (quoting Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 628 (1985)).
28. Section 3 of the Federal Arbitration Act [hereinafter “FAA”] provides:
If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending . . . shall on application of one of the parties stay the trial of the action until such arbitration has been had . . . .
29. Section 4 of the FAA provides that “[a] party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition any United States district court . . . for an order directing that such arbitration proceed in the manner provided for in such agreement.” 9 U.S.C. § 4 (1988).
A. The Wilko Case

Decided in 1953, Wilko v. Swan was the first case to recognize the potential clash between the Arbitration Act and the federal securities laws. The case arose from a lawsuit brought by a customer against the investment firm of Hayden, Stone and Company [hereinafter "Hayden, Stone"]. The investor alleged he was fraudulently induced to purchase a certain number of shares of common stock of Air Associates.

The investor brought suit pursuant to subsection 12(2) of the Securities Act. Prior to the claim, the investor entered into a predispute arbitration agreement with his broker at Hayden, Stone in connection with a margin account agreement. The investor sought enforcement of his subsection 12(2) claim in a judicial forum, federal court. In response, Hayden, Stone moved to stay the judicial proceedings, arguing that the arbitration agreement should be enforced. The Supreme Court held that the Securities Act precluded enforcement of predispute agreements upon two grounds: the literal wording of the Securities Act; and the pro-investor policies underlying the Act.

1. The Holding in Wilko

In order to construe the literal wording of the Securities Act, the Court focused on subsections 12(2), Section 14 and subsection 22(a) of the Act. Specifically, the Court stated that the issue was whether Section 14 of the Act precluded enforcement of the arbitration agreement. Section 14 voids

---

31. Id. at 428-29. Specifically, the investor stated that the broker had induced him to buy shares based on false representation of an upcoming merger. Based on these misrepresentations, the investor was led to believe that the value of the Air stock would increase. Thereafter, the stock value declined.
32. See supra note 3 for the text of subsection 12(2).
33. The district court ruled that the agreement to arbitrate deprived the petitioner of the favorable judicial remedy afforded by the Securities Act and denied the stay. Wilko, 346 U.S. at 430. The court of appeals reversed the district court and concluded that the Act did not prohibit the agreement from referring future controversies to arbitration. Id.
34. Id. at 433-38.
35. Id. at 430-31.
36. Id. at 430.
any condition, stipulation or provision... [that] waive[s] compliance with any provision...” of the Securities Act. 37

The Court considered the arbitration agreement to be a “stipulation” 38 under Section 14 and proceeded to the major focus of the issue — whether subsection 22(a) was the type of “provision” to which Section 14 applied. 39 To ascertain whether subsection 22(a) was the type of “provision” to which Section 14 pertained, the Court relied on the nature of subsection 12(2), the underlying cause of action in the case. 40 It stated that subsection 12(2) created a “special right” for investors; a right or cause of action substantially different from the common law action. 41 The Court explained that subsection 12(2) differed from common law because the burden on the issue of scienter is shifted from the plaintiff to the defendant. 42 The Court further stated that this special right effectuates the underlying policy of the Securities Act; to protect investors by “requir[ing] issuers, underwriters and dealers to make full and fair disclosure” in connection with their sale. 43

The Court concluded that the only way the special right could be effectuated or maintained was through the procedural guarantees of subsection 22(a). 44 The Court enumerated the specific procedural benefits of this subsection and stated that these benefits were not present in an arbitral forum. 45

2. Policy Considerations and the Underlying Purpose of the Securities Act

Besides construing Section 14 literally, as preventing the waiver of the subsection 22(a) judicial forum provision, the Court discussed the underlying policy considerations for construing the forum as judicial, rather than arbitral. The Court reasoned that because the Securities Act is designed to

---

37. Id. Section 14 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.” 15 U.S.C. § 77n (1988).
38. Wilko, 346 U.S. at 434.
39. Id. at 433-38.
41. Wilko, 346 U.S. at 431.
42. Id.; see supra note 3 for text of subsection 12(2).
43. Wilko, 346 U.S. at 431.
44. Id. at 437.
45. Id. at 437-38. Among the benefits noted by the Court were: the choice of bringing an action in a state or federal court, with the removal from state forum being forbidden; the wide choice of venue and nationwide service of process if the federal court is selected; and the lack of applicability of diversity and jurisdictional amount requirement. Id. The Court further noted that these benefits were not present in an arbitral forum. Id.
It was argued that when an investor signs a predispute arbitration agreement, he frequently is in a disadvantageous position and surrenders rights under the Securities Act "at a time when he is less able to judge the weight of the handicap the Securities Act places upon his adversary." The Court also posited that the arbitration process does not adequately protect buyers. Among the deficiencies noted by the Court were the arbitrators' lack of judicial instruction on the law, the lack of written reasons given for awards, the limited nature of judicial review and the power to vacate.

An arbitrator's lack of judicial instruction on the law was particularly problematic. The Court stated that any misconceptions regarding the "legal meaning of such statutory requirements as 'burden of proof,' 'reasonable care' or 'material fact' " on the part of the arbitrator would go unexamined. Under this policy argument, the Court held that the right to choose a judicial forum was a "substantial right" and that any "agreement, restricting that choice, would thwart the express purpose of the statute."

B. Scherk v. Alberto-Culver Co. — A New Interpretation of Wilko

Following the Wilko decision, most federal courts expanded Wilko to include cases involving subsection 10(b) of the Exchange Act. In 1974, the issue of this expansion was brought before the Supreme Court in Scherk v. Alberto-Culver Co. The case involved an international securities transaction between Alberto-Culver, an American company, and a German individual who was the owner of three businesses. The transaction involved a sale of businesses by the German owner to Alberto-Culver along with the purchase of certain trademarks. An allegation of fraud arose in connection with whether the trademarks were encumbered. Within one year of the closing of the agreement, Alberto-Culver alleged that the trademarks "were suspect to substantial encumbrances that threatened" to preclude Culver from deriving any benefit from them.
number of international laws and a contract that included predispute arbitration agreements. The contract provided that arbitration of any dispute would be decided before the International Chamber of Commerce in Paris, France, and that the laws of Illinois would govern the performance and interpretation of the agreement.\textsuperscript{56}

Alberto-Culver sued under subsection 10(b) of the Exchange Act and Rule 10b-5 alleging fraudulent representation regarding the status of the trademarks.\textsuperscript{57} While the Supreme Court held that \textit{Wilko} was not applicable,\textsuperscript{58} it fell short of stating that \textit{Wilko} should not be extended to subsection 10(b) claims in general.\textsuperscript{59} The Court described the contract between the parties as "a truly international agreement"\textsuperscript{60} and distinguished \textit{Wilko} as applying to domestic securities disputes rather than international ones.\textsuperscript{61} The Court also pointed out the unique problems and issues arising from international business transactions.\textsuperscript{62} In general, these types of transactions usually involve complex conflict of law problems for which an understanding of foreign law would be necessary.\textsuperscript{63} Additionally, the Court reasoned that the advantages that \textit{Wilko} gives to investors were "chimerical" in the international context, because an opposing party, by resorting quickly to a foreign court, could deny a security buyer access to an American court.\textsuperscript{64} Thus, the arbitration clause was taken as a "specialized kind of forum-selection" that permitted an orderly choice of situs and procedures to resolve the dispute.\textsuperscript{65} The Court's general concern was the hampering of international trade if predispute arbitration agreements were not enforced.\textsuperscript{66} Accordingly, the Court held that agreements to arbitrate future securities disputes arising out of international transactions should be enforced.\textsuperscript{67}

\begin{itemize}
\item \textsuperscript{56} \textit{Id.} at 508. The enterprises were organized under the laws of Germany and Liechtenstein.
\item \textsuperscript{57} \textit{Id.} at 509-10. Alberto-Culver filed suit against Scherk in an Illinois federal district court. Scherk filed a motion to stay the action pending arbitration in Paris pursuant to the parties' contract. Alberto-Culver then sought a preliminary injunction to restrain Scherk from proceeding with arbitration. The district court issued a preliminary order enjoining Scherk from seeking arbitration. \textit{Id.} The Seventh Circuit applied \textit{Wilko} and affirmed. Alberto-Culver Co. v. Scherk, 484 F.2d 611 (7th Cir. 1973), rev'd, 417 U.S. 506 (1974).
\item \textsuperscript{58} \textit{Scherk}, 417 U.S. at 515.
\item \textsuperscript{59} \textit{Id.} at 514 n.8.
\item \textsuperscript{60} \textit{Id.} at 515.
\item \textsuperscript{61} \textit{Id.} at 515-16.
\item \textsuperscript{62} \textit{Id.} at 515.
\item \textsuperscript{63} \textit{Id.} at 516 n.10.
\item \textsuperscript{64} \textit{Id.} at 518.
\item \textsuperscript{65} \textit{Id.} at 519.
\item \textsuperscript{66} \textit{Id.} at 517-19.
\item \textsuperscript{67} \textit{Id.} at 519-20.
\end{itemize}
However, it was the dictum in Scherk that became even more important than the holding. Justice Stewart raised “a colorable argument” that regardless of the nature of the dispute, Wilko should not be applied to subsection 10(b) claims. The “colorable argument” actually contained four smaller arguments. Justice Stewart argued that Wilko should not apply because: (1) There was no statutory counterpart to subsection 12(2) in the Exchange Act; even though courts had recognized a subsection 10(b) private right of action, the Exchange Act “does not provide the special right that the Court in Wilko found significant;” (3) neither subsection 10(b) nor Rule 10b-5 “speaks of a private remedy to redress violations of the kind alleged here;” and (4) the jurisdictional provision in the Exchange Act, Section 22, was more restrictive than that in the Securities Act.

In the Scherk dissent, Justice Douglas stated that all of the problems associated with arbitration of subsection 12(2) claims listed by Wilko also exist for subsection 10(b) claims. Douglas posited that the “loss of the proper judicial forum carries with it the loss of substantial rights.” Therefore, just as a substantial right is lost when the investor is denied access to a state or federal court under the Securities Act, he likewise suffers when the exclusive federal forum provided by the Exchange Act is taken away.

Federal appellate courts for the most part followed Scherk, rejecting Justice Stewart’s “colorable argument,” and extending Wilko to subsection 10(b) claims. The Wilko holding was extended to subsection 10(b)

68. See also infra notes 93-105 and accompanying text.
69. Scherk, 417 U.S. at 513.
70. Id.
71. Id. at 514.
72. Id. at 513.
73. Id. at 514.
74. Id. at 532. Justice Douglas reiterated the problems listed in Wilko in connection with the inadequacies in the arbitral system such as “subjective findings on the purpose and knowledge of the defendant, questions ill-determined by arbitration without judicial instruction on the law;” no development of a record; no judicial review; the unavailability of extensive pretrial discovery provided by the Federal Rules of Civil Procedure; and lack of a wide choice of venue as provided by Section 27. Id. (quoting Wilko, 346 U.S. at 435).
75. Id.
76. See Id. at 532 n.11. Other lost rights flowing from the refusal to extend Wilko are: the right to a federal forum without a need to meet diversity or jurisdictional amount requirements; nationwide service of process provided by Section 27 of the Securities Act; and the venue provisions of Section 27, which in fact provide the plaintiff with a wider choice than the venue provisions of subsection 22(a) of the Securities Act. See Comment, supra note 8, at 350 n.107 (citing Conover v. Dean Witter Reynolds, Inc., 794 F.2d 520, 526-27 (9th Cir. 1986)).
77. For an excellent discussion of the “colorable argument” see Comment, supra note 8, at 347-66.
78. See, e.g., Surman v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 733 F.2d 59, 61 (8th Cir. 1984); First Heritage Corp. v. Prescott, Ball & Turben, 710 F.2d 1205, 1207 (6th Cir. 1983);
for several reasons. First, it was recognized that the policy behind the Securities Act and the Exchange Act — that of investor protection — is the same, and that both subsections 12(2) and 10(b) effectuate this policy. Second, the statutory framework of the two acts were noted as having virtually the same non-waiver provisions. Third, it was asserted that Congress favored the extension of Wilko because it left Wilko untouched in its 1975 revisions of the federal securities laws and made an exception to the non-arbitrability of securities claims under the Exchange Act by creating a section which allowed for the arbitration of disputes between securities personnel. Finally, the SEC traditionally disfavored arbitration and made clear that its position pertained to the arbitration of disputes under both acts.

C. Dean Witter Reynolds, Inc. v. Byrd — The “Colorable Argument” Revisited

In Dean Witter Reynolds, Inc. v. Byrd, the plaintiff invested $160,000 in securities through Dean Witter. When the value of his account fell by more than $100,000 he alleged violations of subsection 10(b) of the Exchange Act. The question before the Supreme Court was whether a motion

79. See, e.g., Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Weissbuch, 558 F.2d at 835.
80. Moore, 590 F.2d at 827.
81. See, e.g., Weissbuch, 558 F.2d at 836; Ayres, 538 F.2d at 536; cf. Sibley v. Tandy Corp., 543 F.2d 540, 543 n.3 (5th Cir. 1976), cert. denied, 434 U.S. 824 (1977) (adopting the rationale that the similarities between the two acts far outweigh any differences).
82. Ayres, 538 F.2d 532. For a further discussion of the 1975 amendments, see infra notes 157-62 and accompanying text.
83. Section 28 of the Exchange Act was amended to permit compulsory arbitration of securities claims between most securities personnel. See 15 U.S.C. § 78bb(b) (1988).
84. The SEC had adopted Rule 15c2-2 which prohibited brokers from using predispute arbitration clauses in agreements with customers that purport to bind investors to arbitrate when federal securities law claims are at issue. Rule 15c2-2 specifically provided:
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, or to have in effect such an agreement, pursuant to which it effects transactions with or for a customer.

The SEC position on arbitration later changed and Rule 15c2-2 was rescinded. See infra note 198 and accompanying text.
to compel arbitration of arbitrable state claims could be denied when the plaintiff raised both federal securities claims and pendent state claims in connection with a transaction involving a predispute arbitration agreement.87

Prior to Byrd, the courts of appeals lacked uniformity in addressing this issue. Some reasoned that arbitrable state claims were “intertwined” with nonarbitrable federal claims and, therefore, the state claims should not be sent to arbitration.88 As a result, the exclusive jurisdiction of the federal courts in federal securities matters would then be preserved. Other courts of appeals ruled in favor of arbitrating both claims, basing their decision either on the strong federal policy of the Arbitration Act or the refusal to recognize the “intertwining” concept.89 The Supreme Court agreed with the latter position and rejected the “intertwining” concept, holding that even though “piecemeal” litigation would result, the Arbitration Act compelled arbitration of the state claims despite the presence of nonarbitrable federal claims.90

The Court in Byrd carefully avoided the issue of Wilko’s application to subsection 10(b) claims, stating that it was not an issue;91 however, in a concurring opinion, Justice White addressed this issue.92 Additionally, both the majority and concurring opinions provided insight into the Court’s position on the “colorable argument” made in Scherk.93 Even though it chose not to resolve Wilko’s applicability to subsection 10(b) claims, the discussion of the “colorable argument” foreshadowed the impact of Justice Stewart’s dictum in Scherk on future cases.

In Byrd, the Court recognized that Scherk did not interpret Wilko as being inapplicable to subsection 10(b) claims;94 however, it noted that the Scherk Court “questioned” the extension of Wilko to subsection 10(b) claims.95 The Court pointed out that many federal courts had applied Wilko to subsection 10(b) claims.96 Justice White, in his concurring opin-

87. Id. at 214.
88. See, e.g., Byrd v. Dean Witter Reynolds, Inc., 726 F.2d 552 (9th Cir. 1984), rev’d, 470 U.S. 213 (1985); cf. Sibley, 543 F.2d at 543 (holding that since the claims were not “‘intertwined’ in a legal sense,” the state claims should be submitted to arbitration).
90. Byrd, 470 U.S. at 221.
91. Id. at 215-16 n.1.
92. Id. at 224 (White, J., concurring); see infra notes 97-105 and accompanying text.
93. It should be noted that Justice White dissented in Scherk.
95. Id.
96. Id.
ion, restated with some amplification the “colorable argument” raised in Scherk’s majority opinion\textsuperscript{97} and by doing so, gave new impetus to the argument. Justice White interpreted the basis of the Wilko decision to be the interconnection between subsections 12(2) and 22(a), and Section 14 of the Securities Act.\textsuperscript{98} He further explained that the Court’s reasoning in Wilko could not be “mechanically transplanted to the 1934 Act.”\textsuperscript{99}

Justice White recounted the components of the Scherk argument and how they served to distinguish the two acts.\textsuperscript{100} Further, Justice White commented on the express versus the implied nature of subsections 12(2) and 10(b) respectively,\textsuperscript{101} and assigned particular importance to the fact that subsection 10(b) provided only an implied cause of action.\textsuperscript{102} He stated that two conclusions could be drawn from this. First, “[t]he phrase ‘waive compliance with any provision of this chapter,’ [§ 29(a),] is . . . literally applicable.”\textsuperscript{103} Second, Wilko’s “solicitude for the federal cause of action — the ‘special right’ established by Congress . . . is not necessarily appropriate where the cause of action is judicially implied and not so different from the common law action.”\textsuperscript{104} Therefore, the waiver provisions would not be applicable to an implied cause of action.

Justice White also noted that even though the non-waiver provisions of the acts were equivalent, he did not consider this similarity important enough to overcome the dissimilarities between subsections 12(2) and 22(a) of the Securities Act and subsection 10(b) and Section 27 of the Exchange Act.\textsuperscript{105} His comments on the issue attempted to address a point which Justice Stewart had not mentioned in his original argument, i.e., the similarities between the two acts.

D. Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth

In Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth,\textsuperscript{106} the Court did not address the arbitrability of securities law claims but instead addressed claims arising under the federal antitrust laws.\textsuperscript{107} The opinion, however,
contained language directly applicable to Wilko and its possible extension to subsection 10(b).108

Writing for the majority, Justice Blackmun first recognized the "'liberal federal policy favoring arbitration agreements.'"109 Justice Blackmun stated that if arbitration is to be denied, then there must be clear Congressional intent from the text or legislative history "to preclude a waiver of judicial remedies for the statutory rights at issue."110 These comments gave a clear message that because subsection 10(b) was a judicially implied remedy and not an express cause of action created by Congress, the Court was not in a position to extend Wilko when the issue came before it.

The Mitsubishi decision struck directly at Wilko's assumption concerning the inadequacies of the arbitration process. Mitsubishi appeared to lend full support to the arbitration process in concluding:

[A]daptability and access . . . are hallmarks of arbitration. The anticipated subject matter of the dispute may be taken into account when the arbitrators are appointed, and arbitral rules typically provide for the participation of experts . . . . [T]he factor of potential complexity alone does not persuade us that an arbitral tribunal could not properly handle an antitrust matter.111

The dissent in Mitsubishi, authored by Justice Stevens, raised an unexpected argument: Federal statutory laws were an exception to the Arbitration Act112 in that there was "[n]othing in the text of the 1925 Act, nor its legislative history, [that] suggests that Congress intended to authorize the arbitration of any statutory claims."113 Justice Stevens declared that the Court had previously distinguished statutory rights from contractual rights.114 In conclusion, the dissent argued that:

both a fair respect for the importance of the interests that Congress has identified as worthy of federal statutory protection, and a fair appraisal of the most likely understanding of the parties who sign agreements containing standard arbitration clauses, support a presumption that such clauses do not apply to federal statutory claims.115

agreement to arbitrate claims arising under the antitrust laws in an international commercial setting was valid and binding. Id. at 640.

108. Id. at 624-40.
109. Id. at 625 (quoting Moses H. Cone Memorial Hosp. v. Mercury Const. Corp., 460 U.S. 1, 24 (1983)).
110. Id. at 628.
111. Id. at 633-34.
112. Id. at 650 (Stevens, J., dissenting).
113. Id. at 646.
114. Id. at 647.
115. Id. at 650.
E. The Impact of Byrd and Mitsubishi on Wilko's Extension

After Byrd and Mitsubishi, any unanimity between the courts of appeals on Wilko's extension to subsection 10(b) was unequivocally destroyed. The First and Eighth Circuits used Justice White's discussion of the "colorable argument" in his concurring opinion in Byrd as a reason for refusing to apply Wilko to subsection 10(b). These circuits emphasized the dissimilarity between the two acts, in particular the dissimilarity between the express cause of action within subsection 12(2) and the judicially implied cause of action of subsection 10(b). They concluded that the nonwaiver provisions in the Exchange Act did not apply to implied causes of action because they were a judicial creation and, therefore, Congressional intent to extend the judicial forum guarantees to these causes of action was absent. These courts also reiterated the persistent federal policy favoring arbitration and likewise emphasized the strong trend in Supreme Court decisions toward arbitration.

In contrast, the Second, Third, Fifth, Ninth and Eleventh Circuits extended Wilko to subsection 10(b) claims. These courts focused on the similarities between the Securities and Exchange Acts and argued that the judicially implied cause of action of subsection 10(b) was just as important and deserved the same kind of protection as the express causes of action in subsection 12(2).

Additionally, the courts argued other justifications supported the extension to subsection 10(b), such as the binding precedent of Wilko and the

---

116. The failure of the federal courts to address only the similarities and not the specific distinctions between subsections 12(2) and 10(b) as Stewart had originally pointed out in Scherk, may have created this riff. The issues regarding whether subsections 12(2) and 10(b) are a "special right" equivalent to subsection 12(2) and whether an implied remedy is inferior to an explicit private remedy was not considered. Comment, supra note 8, at 349-50, 362-64.


118. See, e.g., Page, 806 F.2d at 297. The court stated: [T]o distinguish Wilko, we rely on the failure of Congress to provide for an express right of action in the 1934 Act. Had Congress regarded an exclusive federal court forum as so critical, it would have been simple for Congress to provide, as it did in the 1933 Act, that individuals be able to bring a cause of action in that forum. Id.

119. See, e.g., id. at 297-98.

120. The Page court used this reason more so than the "colorable argument" as a basis for its decision. Id. The court in Phillips adopted the colorable argument in its entirety and mentioned only briefly the policy favoring arbitration. Phillips, 795 F.2d at 1395, 1398.
public policy concerns of the federal securities laws in protecting investors from their unequal bargaining position.\textsuperscript{121}

\textbf{F. Shearson/American Express, Inc. v. McMahon}

1. The \textit{McMahon} Holding

The Court finally addressed the issue of \textit{Wilko's} application to claims arising from subsection 10(b) disputes in \textit{Shearson/American Express, Inc. v. McMahon}.\textsuperscript{122} The case involved the McMahons, two clients of Shearson/American Express, who jointly held several profit-sharing and pension accounts with the brokerage firm. The McMahons alleged that the registered representative who handled their accounts violated subsection 10(b), with Shearson's knowledge, by making false representations and omissions when advising the McMahons about their accounts. Further, they alleged several violations under the Racketeer Influenced and Corruption Organization Acts [hereinafter \textit{“RICO”}].\textsuperscript{123} The service agreement between the McMahons and their broker contained a predispute arbitration clause. Even though the McMahons had signed this agreement, they argued that its

\begin{itemize}
  \item \textsuperscript{121} Malcolm & Segall, \textit{supra} note 8, at 747 n.145 (citing Wolfe v. E.F. Hutton & Co., 800 F.2d 1032, 1038 (11th Cir. 1986) (en banc)). The Wolfe court stated that Sibley v. Tandy Corp., 543 F.2d 540 (5th Cir. 1976), \textit{cert. denied}, 434 U.S. 824 (1977), “was the law in the former Fifth Circuit since 1976 and in this circuit since its formation. Sibley cited \textit{Scherk} [v. Alberto-Culver Co., 417 U.S. 506 (1974)] and declined to adopt its ‘colorable argument.’ \textit{Byrd} again, added nothing new.” Wolfe, 800 F.2d at 1038. \textit{See also} King v. Drexel Burnham Lambert, Inc., 796 F.2d 59, 60 (5th Cir. 1986) (reasoning that because “[t]he Supreme Court, in its most recent examination of the relevant arbitration principles, expressly declined to pass on the merits of our Circuit’s rule,” it must follow earlier precedent in the Fifth Circuit); Conover v. Dean Witter Reynolds, Inc., 794 F.2d 520, 523, 525 (9th Cir. 1986) (stating that, “to the extent that \textit{Wilko} rests upon the conclusion that an arbitration agreement is an impermissible waiver of enforcement rights arising pursuant to statute or regulations,” it apply to claims pursuant to subsection 10(b) of the Exchange Act and Rule 10b-5 since the waiver provisions of the Securities Act and the Exchange Act are so similar); McMahon v. Shearson/American Express, Inc., 788 F.2d at 94, 96 (2d Cir. 1986) (stating that “[a]lthough \textit{Scherk} [v. Alberto-Culver Co., 417 U.S. 506 (1974)] and \textit{Byrd} may cast some doubt on whether the Supreme Court, if presented with the issue, would hold claims under § 10(b) and Rule 10b-5 to be non-arbitrable, it would be imprudent for us to disregard clear judicial precedent in this Circuit based on mere speculation”); Jacobson v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 797 F.2d 1197, 1201 (3d Cir. 1986) (stating that “[i]n \textit{Byrd} the Court ... expressly declined to resolve the applicability of \textit{Wilko} to section 10(b) claims” and thus \textit{Byrd} “cannot fairly be read as casting any doubt upon the continued authority of” Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 598 F.2d 532 (3d Cir. 1976), \textit{cert. denied}, 429 U.S. 1010 (1977).
  \item \textsuperscript{122} 482 U.S. 220 (1987).
  \item \textsuperscript{123} \textit{Id.} at 223-24. Additionally, the representative was accused of churning the McMahons's accounts.
\end{itemize}
enforcement should be struck down because it was an adhesion contract and *Wilko* was applicable.\textsuperscript{124}

Although the *McMahon* Court held that *Wilko* did not extend to subsection 10(b) or to RICO claims,\textsuperscript{125} it did not overrule *Wilko*. It held that *Wilko* was decided correctly and did apply to Securities Act claims, but added that the *Wilko* Court may have erred in its statutory interpretation of Section 14.\textsuperscript{126}

2. The Court’s Analysis and the Reinterpretation of *Wilko*

   a. The Presumption Favoring Arbitration

   The *McMahon* Court was marked by a close split.\textsuperscript{127} Justice O’Connor wrote the majority opinion and set the tenor of the decision by first declaring the Federal Arbitration Act’s "policy favoring arbitration" and recanting the "judicial suspicion" toward arbitration.\textsuperscript{128} Additionally, the Court stated that the "duty to enforce arbitration agreements is not diminished when a party bound by an agreement raises a claim founded on statutory rights."\textsuperscript{129} The Court explained that the Arbitration Act’s mandate favoring arbitration may be overridden by prohibiting a waiver of a judicial forum that "will be deducible from [the statute’s] text or legislative history, or from an inherent conflict between arbitration and the statute’s underlying purposes."\textsuperscript{130} The Court placed the burden on the McMahons to argue that their claims were excepted from the Arbitration Act by congressional intent.\textsuperscript{131}

\textsuperscript{124} Petitioners had moved to compel arbitration of the agreement pursuant to Section 3 of the Arbitration Act. 9 U.S.C. § 3 (1988). The district court granted arbitration in part, rejecting the adhesion argument and concluding that the subsection 10(b) claims were arbitrable under the *Byrd* decision and the "strong policy favoring the enforcement of arbitration agreements." *McMahon v. Shearson/American Express*, Inc., 618 F. Supp. 384, 388-89 (S.D.N.Y. 1985). It concluded the RICO claims were nonarbitrable. *Id. at 387*. The court of appeals affirmed the district court on the state law and RICO claims, but reversed on the Exchange Act claims. *McMahon v. Shearson/American Express*, Inc., 788 F.2d 94 (2d Cir. 1986) (citing *Wilko* for support). The court of appeals noted that *Byrd* and *Scherk* cast doubt on the issue but cited to "clear judicial precedent in this Circuit" and thus held that *Wilko* must apply. *Id. at 98*.

\textsuperscript{125} *McMahon*, 482 U.S. at 228-29.

\textsuperscript{126} *Id.*

\textsuperscript{127} *McMahon* was a 5-4 decision. *Id. at 221.*

\textsuperscript{128} *Id.* at 226.

\textsuperscript{129} *Id.*

\textsuperscript{130} *Id.* at 227 (citing Mitsubishi Motors v. Soler Chrysler-Plymouth, 473 U.S. 614, 628, 632-37 (1985)).

\textsuperscript{131} *Id.*
The McMahons argued that subsection 29(a) prohibited the waiver of Section 27 of the Exchange Act because that would void a waiver of "any provision" of the Exchange Act. The Court disagreed and stated that subsection 29(a) only prohibited a waiver of the Act's substantive obligations and therefore did not void the waiver of Section 27 of the Act — the procedural provision which confers exclusive district court jurisdiction.

The Court reasoned that "[w]hat the antiwaiver provision of [sub]section 29(a) forbids is enforcement of agreements to waive 'compliance' with the provisions of the statute." The Court further noted that "Section 27 does not impose any duty with which persons trading in securities must 'comply.'" Therefore, "its waiver does not constitute a waiver of 'compliance with any provision' of the Exchange Act under [sub]section 29(a)."

The Court did not believe that the *Wilko* decision compelled a different result. The Court acknowledged that Section 14 and subsection 29(a) contained the same wording, but stated that *Wilko* was expressly based on the Court's belief that arbitration was inadequate and "that a judicial forum was needed to protect the substantive rights created by the Securities Act." In reaching this position, the Court relied on its dicta in *Scherk*, stating that "*Scherk* supports our understanding that *Wilko* must be read as

---

132. *Id.* at 228-29. Subsection 29(a) of the Exchange Act states that "[a]ny 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." 15 U.S.C. § 78cc(a) (1988).
133. *McMahon*, 482 U.S. at 228.
134. *Id*.
135. *Id. But Cf.* Wolfe v. E.F. Hutton & Co., 800 F.2d 1032, 1038 (11th Cir. 1986) (holding that *Wilko* applies to Exchange Act claims). However, Judge Tjoflat, in his concurring opinion, stated:

Were I writing on a clean slate, I might well be inclined to reach a result contrary to the *Wilko* Court. Section 14 of the 1933 Act renders void any provision binding a security purchaser to "waive compliance with any provision of this subchapter". ... A fair reading of this statute would prevent a purchaser from waiving a seller's compliance with the substantive provisions of the Act. ... By agreeing to arbitrate, the purchaser does not waive the Act's protections, but merely agrees to enforce the Act's provisions in a forum other than the courts.
137. *Id*.
138. *Id.* at 228-29.
139. *Id.*
barring waiver of a judicial forum only where arbitration is inadequate to protect the substantive rights at issue.  

\[1\]

**c. The Underlying Purposes of the Exchange Act Are Not Frustrated**

The McMahons raised several arguments which attempted to prove that the underlying purpose of the Exchange Act would be frustrated by arbitration and, therefore, Congress could not have intended such a result.  

\[1\]

The McMahons reasoned that the main purpose of the Exchange Act, to protect investors against broker overreaching, would not be furthered by submission of subsection 10(b) claims to arbitration.  

\[1\]

They argued that predispute agreements were void under subsection 29(a) because they tended to result from broker overreaching,  

\[1\]

posing that *Wilko* barred enforcement of predispute agreements for this reason as well as on the assumption that predispute arbitration clauses were not voluntary.  

\[1\]

The Court refused to accept the McMahons' interpretation of the *Wilko* holding with respect to Section 14 and subsection 29(a),  

\[1\]

and cited *Mitsubishi* for the proposition that by submitting to arbitration "a party does not forgo the substantive rights afforded by statute; it only submits to their resolution in an arbitral, rather than a judicial forum."  

\[1\]

The *McMahon* Court held that the voluntariness of the agreement was irrelevant under subsection 29(a).  

\[1\]

The Court explained that subsection 29(a) is concerned with whether the agreement "weaken[s] their ability to recover under the [Exchange] Act," and not whether the brokers "maneuvered customers" into an agreement.  

\[1\]

Agreements which were challenged under concepts of adhesion or involuntariness only provided grounds for revoking the contracts under contract law, not subsection 29(a).  

\[1\]

The McMahons went on to argue that arbitration did in fact "weaken their ability to recover under the Exchange Act."  

\[1\]

The Court stated that this argument was the "heart" of the Court's decision in *Wilko*.  

\[1\]

---

140. *Id.* at 229 (citing Scherk v. Alberto-Culver Co., 417 U.S. 506 (1974)).
141. *Id.* at 230-31.
142. *Id.* at 230.
143. *Id.*
144. *Id.*
145. *Id.*
146. *Id.* at 229-30 (quoting Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 628 (1985)).
147. *Id.*
148. *Id.* (citing Wilko v. Swan, 346 U.S. 427, 432 (1953)).
149. *Id.* at 230-31.
150. *Id.* at 231.
151. *Id.*
Court, however, based on three assertions, disagreed with this argument. First, the Court restated the underlying reasons behind the *Wilko* finding that arbitration was disadvantageous.\(^1\) The *McMahon* Court concurred with Justice Frankfurter’s dissent in *Wilko*, arguing that the *Wilko* case did not rest on any evidence “‘in the record . . . [or] in the facts of which [it could] take judicial notice’ that ‘the arbitral system . . . would not afford the plaintiff the rights to which he was entitled.’”\(^2\) Second, the Court stated that most of the reasons given in *Wilko* for rejecting arbitration had been subsequently rejected by the Court as a basis for holding claims non-arbitrable.\(^3\) Citing *Mitsubishi*, the Court stated:

> In *Mitsubishi*, for example, we recognized that arbitral tribunals are readily capable of handling the factual and legal complexities of antitrust claims, notwithstanding the absence of judicial instruction and supervision. Likewise, we have concluded that the streamlined procedures of arbitration do not entail any consequential restriction on substantive rights. Finally, we have indicated that there is no reason to assume at the outset that arbitrators will not follow the law; although judicial scrutiny of arbitration awards necessarily is limited, such review is sufficient to ensure that arbitrators comply with the requirements of the statute.\(^4\)

Third, the *McMahon* Court stated that even if *Wilko*’s assumption regarding arbitration was once valid, it was no longer valid because of the Securities and Exchange Commission’s [hereinafter “SEC”] oversight authority with respect to the rules governing self-regulatory organizations [hereinafter “SRO”].\(^5\)

\(^{152}\) *Id.*  
\(^{153}\) *Id.* (quoting *Wilko* v. Swan, 346 U.S. 427, 439 (1953) (Frankfurter, J., dissenting)).  
\(^{154}\) *Id.* at 231-32.  
\(^{155}\) *Id.* at 232 (citations omitted).  
\(^{156}\) *Id.* at 233-34. The Court noted that when *Wilko* was decided, the SEC had only “limited authority over the rules governing self-regulatory organizations (SROs) . . . and this authority appears not to have included any authority at all over their arbitration rules.” *Id.* The Court went on to specifically address the power the SEC now has:

Since the 1975 amendments to § 19 of the Exchange Act, however, the Commission has had expansive power to ensure the adequacy of the arbitration procedures employed by the SROs. No proposed rule change may take effect unless the SEC finds that the proposed rule is consistent with the requirements of the Exchange Act; and the Commission has the power, on its own initiative, to “abrogate, add to, and delete from” any SRO rule if it finds such changes necessary or appropriate to further the objectives of the Act. In short, the Commission has broad authority to oversee and to regulate the rules adopted by the SROs relating to customer disputes, including the power to mandate the adoption of any rules it deems necessary to ensure that arbitration procedures adequately protect statutory rights (footnote omitted).

In the exercise of its regulatory authority, the SEC has specifically approved the arbitration procedures of the New York Stock Exchange, the American Stock Exchange, and
Finally, the McMahons argued that even if subsection 29(a) did not specifically void predispute arbitration agreements, Congress had subsequently intended that subsection 29(a) do so.157 Specifically, the McMahons’ argument was that Congress had ample opportunity in its 1975 amendments to correct the federal courts’ application of *Wilko* to the Exchange Act, but it had not.158 Therefore, by virtue of its inaction, Congress approved of the extension to subsection 10(b) cases.159 This “absence of action” argument was based on a sentence from the Conference Report, which the McMahons contended ratified *Wilko’s* extension to the Exchange Act. The Court, quoting the Conference Report, stated:

The Senate bill amended section 28 of the Securities Exchange Act of 1934 with respect to arbitration proceedings between self-regulatory organizations and their participants, members, or persons dealing with members or participants. The House amendment contained no comparable provision. The House receded to the Senate. It was the clear understanding of the conferees that this amendment did not change existing law, as articulated in *Wilko v. Swan*, 346 U.S. 427 (1953), concerning the effect of arbitration proceedings provisions in agreements entered into by persons dealing with members and participants of self-regulatory organizations.160

The McMahons argued that the acknowledgement of *Wilko* in a revision of the Exchange Act meant that the conferees were aware of lower court decisions extending *Wilko* to subsection 10(b) claims, and thus there was an intention to approve of these decisions.161 The Court disagreed with this reading and contended that Congress could not have intended this result without enacting into law any provision remotely addressing that subject.162

---

157. *Id.* at 234-38.
158. *Id.* at 234-35.
159. *Id.* at 237.
161. *Id.* at 237.
162. *Id.* at 237-38. The Court further argued that the Report was ambiguous and would not support such a reading. *Id.*
3. Blackmun’s Dissent

Justice Blackmun concurred with the majority’s decision to uphold the arbitration of RICO claims but disagreed with the Court’s refusal to extend Wilko to subsection 10(b) claims.\(^\text{163}\) He based his dissent primarily on three arguments: (1) Congress had adopted Wilko’s application to subsection 10(b) in its 1975 amendments to this act and related legislative history;\(^\text{164}\) (2) the majority erred in their construction of Wilko and construed its holding too narrowly;\(^\text{165}\) and (3) many of the problems with the arbitral process upon which the Wilko Court based its decision still exist.\(^\text{166}\) Each of the three arguments are discussed below.

\textit{a. 1975 Amendments}

Blackmun first noted that the 1975 amendments were regarded as “the ‘most substantial and significant revision of this country’s federal securities laws since the passage of the Securities Exchange Act in 1934.’”\(^\text{167}\) Justice Blackmun argued that although the Conference Report did not expressly state Congress’ approval of Wilko’s extension to Exchange Act claims, he did not agree with the “difficulties” that the majority opinion stated were created by a lack of direct reference.\(^\text{168}\)

Blackmun contended that in enacting amendments regarding exceptions to subsection 29(a), Congress was enacting provisions “directly related to the general subject of Wilko and its extension to Exchange Act claims.”\(^\text{169}\) By this argument, Blackmun clearly contradicted the Court’s assumption that these provisions were not remotely addressing that subject.

\textit{b. Misinterpretation of Wilko}

Justice Blackmun then went on to contend that Wilko was given an “overly narrow” reading in order to fit into a “syllogism” advanced by the SEC, namely that: “(1) Wilko is really a case concerning whether arbitration was adequate for the enforcement of the substantive provisions of the securities law; (2) all of the Wilko Court’s doubts as to arbitration’s ade-

\(^{163}\) Id. at 242-43 (Blackmun, J., concurring in part, dissenting in part).
\(^{164}\) Id. at 246-48.
\(^{165}\) Id. at 249-57.
\(^{166}\) Id. at 259-68.
\(^{167}\) Id. at 246 (citing Herman & MacLean v. Huddleston, 459 U.S. 375, 384-85 (1983), and quoting Securities Act Amendments of 1975: See Hearings on S. 249 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 94th Cong., 1st Sess., 1 (1975)).
\(^{168}\) McMahon, 482 U.S. at 247 n.5 (Blackmun, J., concurring in part, dissenting in part).
\(^{169}\) Id.
quacy are outdated; (3) thus \textit{Wilko} is no longer good law."'\textsuperscript{170} Blackmun pointed out that the \textit{McMahon} Court was ignoring the true ground upon which \textit{Wilko} stood; \textit{Wilko} held that the text and legislative history of the Securities Act — not problems with arbitration — established the Securities Act as an exception to the Arbitration Act.\textsuperscript{171} Blackmun cited \textit{Mitsubishi} as well as the \textit{Wilko} opinion itself to support this position. \textit{Mitsubishi} stated:

'Just as it is the congressional policy manifested in the Federal Arbitration Act that requires courts liberally to construe the scope of arbitration agreements covered by that Act, it is the congressional intention expressed in some other statute on which the courts must rely to identify any category of claims as to which agreements to arbitrate will be held unenforceable. . . . We must assume that if Congress intended the substantive protection afforded by a given statute to include protection against waiver of the right to a judicial forum, that intention will be deducible from text or legislative history. . . .''\textsuperscript{172}

Blackmun noted that there was a thorough discussion in \textit{Wilko} of the legislative history and purposes underlying the Act, primarily that of investor protection.\textsuperscript{173} This was in contrast to the lack of discussion of these policies in the majority opinion in \textit{McMahon}.\textsuperscript{174} The \textit{Wilko} Court held that the purpose could only be advanced by adjudication in a judicial forum.\textsuperscript{175}

\begin{itemize}
  \item \textsuperscript{170} \textit{Id.} at 249-50 (citations omitted).
  \item \textsuperscript{171} \textit{Id.} at 250-51.
  \item \textsuperscript{172} \textit{Id.} (quoting Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 627-28 (1985)).
  \item \textsuperscript{173} \textit{Id.} at 251-52.
  \item \textsuperscript{174} \textit{Id.}
  \item \textsuperscript{175} \textit{Id.} at 252. Blackmun explained that \textit{Wilko} provided that a predispute arbitration agreement involving subsection 12(2) claims would constitute a "'waiver' of a provision of the Act, \textit{i.e.,} the right to the judicial forum embodied in [subsection 22(a)]." \textit{Id.} Blackmun noted that \textit{Wilko} specifically referred to the policy of investor protection underlying the Act by saying:

While a buyer and seller of securities, under some circumstances, may deal at arm's length on equal terms, it is clear that the Securities Act was drafted with an eye to the disadvantages under which buyers labor. Issuers of and dealers in securities have better opportunities to investigate and appraise the prospective earnings and business plans affecting securities than buyers. It is therefore reasonable for Congress to put buyers of securities covered by that Act on a different basis from other purchasers. When the security buyer, prior to any violation of the Securities Act, waives his right to sue in courts, he gives up more than would a participant in other business transactions. The security buyer has a wider choice of courts and venue. He thus surrenders one of the advantages the Act gives him and surrenders it at a time when he is less able to judge the weight of the handicap the Securities Act places upon his adversary.

\end{itemize}
Blackmun also noted that the Securities Act was passed after the Arbitration Act. 176

Additionally, Blackmun took issue with the majority’s interpretation of Section 14. 177 Again, Blackmun asserted that Wilko had been misread in its interpretation of the statute. 178 The McMahon majority suggested that subsection 29(a), which is the same as Section 14, can only be read to mean that an investor cannot waive security-investment personnel’s “compliance” with a duty under the statute. 179 Blackmun contended that the Wilko Court did not read the non-waiver provision so narrowly and suggested that the provision could also be read to mean that “an investor could not waive his compliance with the provision for dispute resolution in the courts.” 180 In the latter interpretation, it is irrelevant that Section 27 does not impose a duty, therefore, the reason for not applying subsection 29(a) to Section 27 does not exist. 181

Finally, Blackmun noted that the majority’s discussion of the inadequacies of arbitration appeared “after the Court had concluded that the language, legislative history, and purposes of the Securities Act mandated an exception to the Arbitration Act for these securities claims.” 182

After providing his interpretation of Wilko, Blackmun then addressed the core issue, i.e., whether the “language, legislative history, and purposes of the Exchange Act call[ed] for an exception to the Arbitration Act for [subsection] 10(b) claims.” 183 Blackmun concluded that Wilko should apply because of the similarities in wording of the waiver provisions and the analogous purposes in both the Securities Act and the Exchange Act. 184

c. Problems with Arbitration

Blackmun’s final argument contended that even if Wilko was narrowly read as having been based on the inadequacies of arbitration, the majority decision was still erroneous because many of these problems continue to exist. 185 Blackmun was uncertain that the SEC’s oversight of the SRO’s arbitration procedures would overcome these problems and be adequate to

176. Id. at 251.
177. Id. at 253-54 n.9.
178. Id.
179. Id.
180. Id.
181. Id.
182. Id. at 254.
183. Id. at 256-57.
184. Id.
185. Id. at 257-68.
protect investor rights under the federal securities acts. Even though Blackmun noted that there had been some improvements in the arbitration process since Wilko, such as the development of a uniform code, he argued that the characteristics which make arbitration attractive create the very problems that are at odds with the protection of the investor. Blackmun explained that the same problems exist post-Wilko as they did pre-Wilko: The preparation of a record of procedures is still not required; arbitrators are still not bound by procedures and are in fact discouraged by their associations from giving reasons for their decisions; and judicial review is still limited.

Additionally, Blackmun questioned the SEC's turnaround in interpreting McMahon as supporting arbitration claims in light of the SEC's past dissatisfaction with the use of predispute arbitration agreements and the

186. Id.
187. Id. at 258-59.
188. Id. at 259.
189. Id. at 261-64. Justice Blackmun stated:
The Court, however, fails to acknowledge that, until it filed an amicus brief in this case, the Commission consistently took the position that § 10(b) claims, like those under § 12(2), should not be sent to arbitration, that predispute arbitration agreements, where the investor was not advised of his right to a judicial forum, were misleading, and that the very regulatory oversight upon which the Commission now relies could not alone make securities-industry arbitration adequate.

Id. at 262 (footnote omitted).

190. Id. at 253 n.22. Justice Blackmun stated:
The Commission, in a release issued in 1979, explained its opposition to predispute arbitration agreements:

It is the Commission's view that it is misleading to customers to require execution of any customer agreement which does not provide adequate disclosure about the meaning and effect of its terms, particularly any provision which might lead a customer to believe that he or she has waived prospectively rights under the federal securities laws, rules thereunder, or certain rules of any self-regulatory organization. Customers should be made aware prior to signing an agreement containing an arbitration clause that such a prior agreement does not bar a cause of action arising under the federal securities laws. If a broker-dealer customer's agreement contains an arbitration clause, it must be consistent with current judicial decisions regarding the application of the federal securities laws to predispute arbitration agreements.

The Commission is especially concerned that arbitration clauses continue to be part of form agreements widely used by broker-dealers, despite the number of cases in which these clauses have been held to be unenforceable in whole or in part. Requiring the signing of an arbitration agreement without adequate disclosure as to its meaning and effect violates standards of fair dealing with customers and constitutes conduct that is inconsistent with just and equitable principles of trade. In addition, it may raise serious questions of compliance with the anti-fraud provisions of the federal securities laws.

Id. (citing Broker-Dealers Concerning Clauses in Customer Agreements Which Provide for Arbitration of Future Disputes, 44 Fed. Reg. 40462, 40464 (1979) (footnotes omitted)).

Justice Blackmun concluded:
rule it effected to prohibit them.\textsuperscript{191} He posited that the underlying reasons for the SEC's long history in opposing arbitration should weigh more heavily than its recent turnaround.\textsuperscript{192} Finally, Blackmun found that the SEC's oversight with the SRO's would not protect investors because the SEC's authority was limited to the form of general review and supervision of the SRO's and their rules.\textsuperscript{193} Blackmun added that the Court's complacent acceptance was "alarming" in light of recent and numerous abuses and violations on Wall Street.\textsuperscript{194} Blackmun argued these problems indicate that industry self-regulation is not functioning, and therefore, the SRO's regulation of arbitration may suffer the same fate.\textsuperscript{195}

\section*{IV. Events Following the McMahon Decision}

Following the McMahon decision, significant questions were raised concerning Wilko's continued validity. Lower courts were left with stare decisis which the Supreme Court had all but effectively dismissed. As a result, the opinions of these courts were inconsistent as to the continued application of Wilko to Securities Act claims. Some circuits noted that McMahon

\begin{quote}
As the quoted material suggests, the Commission was aware of the court cases concerning such arbitration agreements. In the release, the Commission discussed at length this Court's Wilko decision and cases in which courts had extended it to § 10(b) claims. . . . The thrust of the release is that the Commission not only accepted the case law but also, for its own reasons, thought that the arbitration agreements in the predispute context were inappropriate and misleading. . . . The Commission acknowledges that in 1975 it even filed an amicus brief in Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 538 F.2d 532 (3d Cir. 1976), cert. denied, 429 U.S. 1010 (1976), in which it supported the extension of Wilko to § 10(b) claims.

\textit{Id.} at 263-64 n.22 (citations omitted).
\end{quote}

\textit{Id.} at 264 (citing Rule 15c2-2). Rule 15c2-2 states:

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, or to have in effect such an agreement, pursuant to which it effects transactions with or for a customer.

17 C.F.R. § 240.15c2-2(a) (1986).

\textsuperscript{192} Blackmun explained that the Court was swayed by the 1975 amendments giving the SEC power "to oversee the rules and procedures of the SROs, including those dealing with arbitration." McMahon, 482 U.S. at 262.

\textsuperscript{193} \textit{Id.} at 265. The SEC "neither policies nor monitors the results of [SRO] arbitrations for possible misapplications of securities laws or for indications of how investors fare in these proceedings." \textit{Id.}

\textsuperscript{194} \textit{Id.} at 265-66.

\textsuperscript{195} \textit{Id.}
had questioned Wilko but considered Wilko judicial precedent. Other courts regarded the McMahon decision as having eroded the rationale of Wilko.

After McMahon, and in anticipation of the increased use of arbitration, the SEC rescinded Rule 15c2-2 and sent to the Securities Industry Conference on Arbitration [hereinafter “SICA”] a number of recommendations for changes in SRO arbitration. Additionally, the SEC considered a two-part recommendation which would have: (1) proposed an amendment to the Exchange Act to prohibit a broker-dealer from conditioning investor access to brokerage services on the signing of predispute arbitration agreements; and (2) asked the SRO’s to use their broad rule making authority to effect the same result. The SEC, however, voted unanimously to


198. In rescinding the rule, the Commission stated: [The Supreme Court held in Shearson/American Express v. McMahon that predispute agreements to arbitrate claims arising under the Securities Exchange Act of 1934 are enforceable. In addition, although the Court did not expressly overrule Wilko v. Swan which held that predispute agreements to arbitrate claims arising under section 12(2) of the Securities Act of 1933 were not enforceable, the Court’s reasoning raised questions regarding the continuing vitality of that decision. In light of these developments, the Commission believes that Rule 15c2-2 is no longer appropriate or accurate and, accordingly, should be rescinded. Rescission of Rule Governing Use of Predispute Arbitration Clauses in Broker-Dealer Customer Agreements. 52 FED. REG. 39,217 (1987).

199. Before the 1975 amendments, there was no uniform code on arbitration and the SROs had different rules for the administration of arbitration disputes. Several SROs proposed to the SEC that a securities industry task force be established to develop the code. SICA, which consists of representatives from various SROs, the public, and the Securities Industry Association [hereinafter “SIA”], was thereafter established. SICA developed the Uniform Code of Arbitration and developed a handbook on procedures. See Katsoris, Securities Arbitration After McMahon, 16 FORDHAM URBAN L.J. 731 (1989) for a discussion of the SICA and the SIA.

200. See Katsoris, supra note 199, at 369 n.54 (noting the letter from the SEC to the SICA discussing the completed proposals). For a discussion of these recommendations and others, see Fitterman, McGuire, & Love, SEC Initiatives for Changes in SRO Arbitration Rules, PLI CONFERENCE REPORT, 813 (Sept. 26, 1988).

oppose such legislation.\textsuperscript{202} The SRO’s then proposed new rules requiring all predispute clauses to be highlighted, clarifying who will qualify as a public arbitrator, expanding the form and content of the arbitration reward to provide more detailed information, and requiring that a record of the proceeding be kept.\textsuperscript{203}

In addition to the reaction of the courts to \textit{McMahon}, certain members of Congress were stunned by the SEC’s sudden change in its position against arbitration and vowed to investigate the matter.\textsuperscript{204} In its investigation, Congress considered new legislation such as the Securities Arbitration Reform Act of 1988 [hereinafter “Reform Act”] which attempted to impose certain rules and guidelines for the arbitration of securities disputes.\textsuperscript{205} The Reform Act addressed the concern that predispute arbitration agreements were adhesion contracts.\textsuperscript{206} It also addressed the procedural inadequacies of the arbitral system to protect investors.\textsuperscript{207}

\textsuperscript{202} SEC Votes to Oppose Mandatory Arbitration Clauses, 20 Sec. Reg. & L.J. Rep. 1053 (1988). SEC Chairman David Ruder explained that mandatory clauses are not prevalent in cash accounts; it is estimated that 39% of an estimated 13 million cash accounts contained mandatory arbitration agreements. Commissioner Ruder stated that he had confidence that the SROs could handle any problems without the need for legislation, which would cause undesirable inflexibility. \textit{Id.}


\textsuperscript{204} Comment, supra note 8, at 352 n.120 (quoting letter from John D. Dingell, Chairman of the Subcommittee on Oversight and Investigation of the Committee on Energy and Commerce to John S.R. Shad, Chairman of the Securities and Exchange Commission (Feb. 11, 1987)).


\textsuperscript{206} Edward Markey of Massachusetts stated that the predispute agreements were in fact contracts of adhesion, and that “[r]estoring to investors the right to choose judicial resolution of future disputes is a basic investor protection that will go some distance toward restoring individual investor confidence so severely damaged after the October crash.” \textit{CONG. REC.} E2245 (daily ed. June 30, 1988) (introduction of the Securities Arbitration Reform Act of 1988, H.R. 4960 by Rep. Edward Markey).

\textsuperscript{207} The reasoning behind the Reform Act was expressed by Rick Boucher: The arbitration system the securities industry forces onto these customers is run by the exchanges themselves. There are no rules of evidence. The arbitrators are paid by the exchanges. The locations and times of the hearings are often set at the convenience of the arbitrators and brokers with little regard for the investor seeking redress. When the investor does win awards it is seldom for the full amount of loss, and in some cases do not even cover the cost of travel and attorneys fees. There are no written decisions and few records are kept. Nothing is made public and appeals to the courts are extremely unlikely except in the most blatant [sic] cases of misconduct, and not necessarily even in those cases.
In 1989, however, the Supreme Court finally resolved the Wilko dilemma in *Rodriguez de Quijas v. Shearson/American Express*.

V. THE RODRIGUEZ DECISION

A. The Facts

The petitioners in *Rodriguez de Quijas v. Shearson/American Express*\(^{208}\) invested approximately $400,000 in securities using Shearson/American Express as their broker. The value of the petitioners’ investment declined and suit was brought pursuant to subsection 12(2) of the Securities Act and several other federal securities sections and state claims.\(^{209}\) The petitioners alleged that their losses occurred as a result of unauthorized and fraudulent transactions by the broker-agent in charge. The parties had entered into a predispute arbitration agreement.

The district court ordered all claims to be submitted to arbitration except those raised under subsection 12(2) of the Securities Act,\(^{210}\) citing Wilko as the basis of denying arbitration.\(^{211}\) Upon review of the lower court’s holding, the court of appeals concluded that subsequent Supreme Court decisions reduced Wilko to “obsolescence.”\(^{212}\)

B. The Holding

As Blackmun had prophesied in *Shearson/American Express, Inc. v. McMahon*,\(^{213}\) the Rodriguez Court overruled Wilko, utilizing many of the arguments that had been enumerated previously in *McMahon*. These arguments which focused primarily on the Court’s refusal to extend Wilko to subsection 10(b),\(^{214}\) are set forth below.

1. The Reason for Applying Section 14 to Procedural Provisions No Longer Exists

The Rodriguez Court reasoned that the Wilko Court could have just as easily applied Section 14 of the Securities Act to the substantive provisions “without including the remedy provisions,” but chose not to for two rea-
First, the Court stated that *Wilko* found that “arbitration lacked the certainty of suit.”\(^{216}\) Second, “the right to select the judicial forum” was based on putting buyers and sellers on more equal footing.\(^{217}\) The Court, thereafter, proceeded to recant these reasons based on the following three arguments:

**a. Wilko Was Outmoded in Its View on Arbitration**

The Court struck down the first reason stating it rested more on “the old judicial hostility to arbitration” instead of realities.\(^{218}\) The Court cited *Mitsubishi* for the proposition that in submitting disputes to the arbitration process, the buyer does not “forgo the substantive rights afforded by the statute . . . [but] only submits to their resolution in [a different] forum.”\(^{219}\) The Court stated further that *Wilko* had “fallen far out of step with our current strong endorsement of the federal statutes favoring this method of resolving disputes.”\(^{220}\) Additionally, the Court cited *McMahon*, noting the recent expansion of SEC powers as being another reason for supporting arbitration.\(^{221}\)

**b. The Procedural Provisions Were Not Essential Because They Could Be Waived: A Reinterpretation of Section 14**

The *Rodriguez* Court posited that:

> [o]nce the outmoded presumption of disfavoring arbitration proceedings is set to one side, it becomes clear that the right to select the judicial forum and the wider choice of courts are not such essential features of the Securities Act that section 14 is properly construed to bar any waiver of these provisions.\(^{222}\)

The Court also stated “[n]or are they so critical that they cannot be waived under the rationale that the Securities Act was intended to place buyers of securities on equal footing with sellers.”\(^{223}\)


\(^{216}\) *Id.*

\(^{217}\) *Id.* at __, 109 S. Ct. at 1919-20.

\(^{218}\) *Id.* at __, 109 S. Ct. at 1920.

\(^{219}\) *Id.* (citing Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, 473 U.S. 614, 628 (1985)).

\(^{220}\) *Id.*

\(^{221}\) *Id.* at __, 109 St. Ct. at 1921.

\(^{222}\) *Id.* at __, 109 St. Ct. at 1920.

\(^{223}\) *Id.* The Court stated that in order to advance the objective of putting buyers on equal footing with sellers, *Wilko* had identified two different kinds of provisions: substantive and procedural. *Id.* at __, 109, St. Ct. 1920-21. The Court enumerated the specific procedural provisions highlighted in *Wilko*: 
In this argument, the Court attempted to reinterpret Section 14. It was the opinion of the Court that reinterpretation was necessary because the presumption against arbitration was removed and, therefore, the protective guarantees of Section 14 were no longer essential. Additionally, proof of their lack of necessity was shown as the Securities Act itself provided for waiver of these guarantees by giving plaintiffs the option to file in state court, thus waiving the judicial advantage of federal court jurisdiction.

The Court explained that because Section 14 and subsection 29(a) have virtually the same wording, and because the McMahon Court refused to read subsection 29(a) as prohibiting arbitration, Section 14 should thus be read the same way. The Court, however, noted the difference between the jurisdictional provisions of the two acts. The Court reasoned that the concurrent jurisdiction statute supported the concept of providing a selection of forum. It concluded that the opportunity to select arbitration was a type of forum shopping, advancing this objective.

2. The Burden of Exception from the Arbitration Act Was Not Carried

The Rodriguez Court cited McMahon's emphasis on the application of the Arbitration Act and the strong federal policy in favor of the arbitration of securities disputes. The Court cited to the Arbitration Act's preference for arbitration agreements claiming they are "valid, irrevocable, and enforceable, save upon such grounds as exist in law or in equity for the revocation of any contract." The Court added that the Arbitration Act

---

[The statute's broad venue provisions in the federal courts; the existence of nationwide service of process in the federal courts; the extinction of the amount-in-controversy requirement that had applied to fraud suits when they were brought in federal courts under diversity jurisdiction rather than as a federal cause of action; and the grant of concurrent jurisdiction in the state and federal courts without possibility of removal.

---

Id. at 1920.
224. Id. at 1920-21.
225. Id. at 1921.
226. Id. at 1921.
227. Id.
228. Id.
229. Id.
230. Id.
231. Id.
232. Id.
233. Id. (quoting 9 U.S.C. § 2 (1988)).
would not be applied, however, if the “party opposing arbitration carries
the burden of showing that Congress intended in a separate statute to pre-
clude a waiver of judicial remedies, or that such a waiver of judicial reme-
dies, inherently conflicts with the underlying purposes of that other
statute.”

The Court quoted Justice Frankfurter’s dissent in Wilko stating that “‘[t]here is nothing in the record before us, nor in the facts of which we can take judicial notice, to indicate that the arbitral system . . . would
not afford the plaintiff the rights to which he is entitled.’”

Additionally, Section 2 of the Act disallows arbitration where the party
opposing the arbitration presents “well-supported claims that the agree-
ment to arbitrate resulted from the sort of fraud or overwhelming economic
power that would provide grounds ‘for the revocation of any contract.’”

The Court explained that this exception to the Act “is in harmony with the
Securities Act’s concern to protect buyers of securities by removing ‘the
disadvantages under which buyers labor’ in their dealings with sellers.”

The Rodriguez Court concluded that the plaintiffs had not carried their bur-
den on either ground.

3. Wilko and McMahon Created a Disharmony Between the Two Acts

Finally, the Court reasoned that it would be “undesirable” for Wilko
and McMahon to co-exist. In general, their inconsistencies would run
counter to the similar regulatory scheme of the two federal securities
acts. Additionally, litigants could manipulate their allegations in order
to fit under either one of the acts. The Court concluded this would un-
dermine the policy of harmonious construction.

VI. THE RODRIGUEZ ANALYSIS AND RESULTING PROBLEMS

A. The Acceptance of McMahon’s Reinterpretation of Wilko

For the most part, the congressional intent behind the Securities Act
was bypassed in the Rodriguez decision in favor of the Arbitration Act.
The Court’s major focus in Rodriguez was the acceptance of McMahon’s

234. Id. (citing Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 226-27 (1987)).
235. Id. (quoting Wilko v. Swan, 346 U.S. 427, 439 (1953) (Frankfurter, J., dissenting)).
236. Id. (quoting Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, 473 U.S. 614, 627
(1985)).
237. Id. (quoting Wilko v. Swan, 346 U.S. 427, 435 (1953)).
238. Id.
239. Id. at ___, 109 S. Ct. at 1922.
240. Id.
241. Id.
242. Id.
interpretation of Wilko, that arbitration was insufficient to address securities law claims. Even though Rodriguez recognized that the Wilko Court based its holding on "the language, purposes, and legislative history of the Securities Act, and concluded that the agreement to arbitrate was void,"243 this acknowledgement was only dicta. Therefore, in order to overrule the Wilko holding, the Rodriguez Court had to reinterpret the basis for the Wilko holding.

If the Wilko decision had in fact been based on Congress' intent to exclude the arbitration process from subsection 12(2) claims, as interpreted from the "text, purposes, and legislative history of the Securities Act," then the Rodriguez Court could not have overruled it. Congress had done nothing in the thirty-five years following the Wilko case to express a different intent. If the Rodriguez Court had recognized and accepted Congressional intent as the basis for the Wilko decision, it would have been irrelevant to discuss whether or not the arbitration process had improved. Congressional intent, not the status of the arbitral process, would determine the issue. Therefore, even if improvements were made and certain procedural changes had occurred, it would have been irrelevant.

B. Problems with Arbitration Go Unaddressed

Even if the overruling of Wilko could be justified on the grounds that arbitration is no longer inadequate, it is stunning to see the Court's lack of explanation for its change in position. First, the Court stated that the suspicion regarding the merits of arbitration that existed in the days of Wilko no longer exist. As proof, it pointed to its strong endorsement of the arbitration process in past decisions.244 This argument posits that because there is currently strong judicial support for arbitration, the process therefore has become adequate. Unfortunately, it is still possible to place the judicial stamp of approval on something even when it is inherently wrong. The Court did this in Rodriguez, and thus failed to address the inadequacies that were enumerated in Wilko and reemphasized by Justice Blackmun in the McMahon dissent.245

245. See supra notes 185-95 and accompanying text.
Second, the Rodriguez Court cited Mitsubishi for the proposition that substantive rights are not waived in arbitration.\textsuperscript{246} This argument fails because Mitsubishi is not a securities law case and, in fact, the case actually supports Wilko.\textsuperscript{247}

Third, the Court stated that arbitration had been upheld in other federal statutory cases.\textsuperscript{248} This argument stands for the proposition that since arbitration has been upheld in other federal statutory cases then it should be extended to the Securities Act. At the core of this argument is the denial of the importance of the unique congressional intent as to each federal statute and more specifically, the unique intent underlying the Securities Act. In claiming that arbitration was upheld in other statutory cases, the Court assumes that the securities laws are like other federal statutory laws. If this is so, the Court does not recognize the distinct regulatory scheme and purpose of the different federal laws and does not explain why their similarities would support their being treated in the same manner.

Finally, the Rodriguez Court utilized the reasoning of the McMahon opinion regarding the benefits of arbitration, as well as the importance of SEC oversight for improving the system.\textsuperscript{249} The Court, however, failed to address the inadequacies in the arbitration process that have existed since Wilko, as pointed out by Justice Blackmun's dissent in McMahon, and the impact that these inadequacies might have on investor protection. If the core issue is not congressional intent but whether the status of arbitration

\textsuperscript{246} Rodriguez, ___ U.S. at __, 109 S. Ct. at 1920. \textit{But see} Wilko v. Swan, 346 U.S. 427, 438 (1953). The Wilko court stated: "We said the right to select the 'forum' even after the creation of a liability is a 'substantial' right and that the agreement, restricting that choice, would thwart the express purpose of the statute." \textit{Id.}

\textsuperscript{247} The Court stated in Mitsubishi: Just as it is the congressional policy manifested in the Federal Arbitration Act that requires courts liberally to construe the scope of arbitration agreements covered by that Act, \textit{it is the congressional intention expressed in some other statute on which the courts must rely to identify any category of claims as to which agreements to arbitrate will be held unenforceable.}

\textsuperscript{248} Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 627 (1985) (emphasis added). \textit{See also} Comment, supra note 8, at 371 n.249 for the proposition that, unlike some courts' interpretations of the Mitsubishi decision, the Mitsubishi Court did not require the policies behind the Arbitration Act and those of other federal securities laws to be weighed equally; see, e.g., Page v. Moseley, Hallgarten, Estabrook & Weeden, Inc., 806 F.2d 291, 297 (1st Cir. 1986) (Arbitration Act should receive equal deference). Instead, the Mitsubishi Court explained that courts must look at the congressional intent in the statute at issue to determine if Congress permitted waiver of a judicial forum. Mitsubishi, 473 U.S. at 626-27.

\textsuperscript{249} Rodriguez, ___ U.S. at __, 109 S. Ct. at 1920; see cases cited supra note 244. The McMahon case is the only securities case cited, however, in which there is no analysis of the similarities or dissimilarities between the two acts to support the argument.
has improved sufficiently to protect investors under the securities acts, then this is the basic question which must be answered. This question, however, is never truly addressed by the Court. Instead, great reliance and hope are placed on the SEC to address any inadequacies. This assumes that the power of the SEC is broader than it is, and additionally, does not address the impact that limitations on this power may have on investor protection. Additionally, even if SEC powers are eventually broadened, investors who have claims prior to the expansion will be affected.

C. The Use of the Federal Policy Toward Favoring Arbitration as a Basis for Statutory Interpretation

The second part of the Court's analysis, the interpretation of Section 14 of the Securities Act as supporting arbitration, is also puzzling. First, it assumes that the status of arbitration as it now exists bears upon the statutory construction of Section 14. Again, this assumption supports the Court's adoption of the McMahon interpretation of Wilko. Only under the McMahon interpretation could it be said that Section 14 was originally misconstrued and that Section 14 applied to the remedial provisions because of the inadequacies of the arbitration process at the time of Wilko. If Wilko's holding, as originally interpreted, had been adopted by Rodriguez, Section 14 and the status of arbitration could not have been interconnected.

Second, to bolster its argument that "remedial protections are non-essential," and, therefore, can be waived, the Court reasoned that these protections are not essential because the plaintiff may waive them by filing in state court. This is at best a form of bootstrap reasoning. This argument is problematic in four ways. First, it assumes that because these provisions are waivable by the plaintiff, they are "not essential" to the policy underlying the Securities Act. However, this argument ignores the fact that the waiver provision under the Act refers to the waiver of one judicial forum in favor of another. In predispute arbitration agreements, the investor waives a judicial forum in favor of a non-judicial forum. The question of "essentialness" is not concerned with the availability of different judicial forums, but rather whether it is "essential" that a judicial forum be preserved to effectuate the purpose of the Securities Act. The Court fails to address this question.

250. See supra note 187 and accompanying text on the inadequacies of SEC oversight.
Second, the term "essential" finds no correlative wording in Section 14 or subsection 22(a).\textsuperscript{253} Also, there is no distinction between essential and non-essential provisions in \textit{Wilko}. Instead, \textit{Wilko} applied Section 14 to the procedural provisions on the basis of both the statutory language in Section 14 and the underlying purpose of the Act without resorting to artificial terminology that has no bearing on the statutory language.\textsuperscript{254}

Third, the \textit{Rodriguez} Court stated that the prohibition in Section 14 against waiver of "compliance with any provision" cannot be meant to apply to the procedural provisions. This is in direct opposition to the original reading of \textit{Wilko} and ignores the reasoning behind the interpretation which includes these provisions, that is, the underlying policy of investor protection. The Court's argument would be relevant only if the policy had changed.

Fourth, the Court's argument that the effect of filing in state court is analogous to arbitrating is problematic as well in that both cause waiver of federal procedural advantages.\textsuperscript{255} The Court stated that "the grant of concurrent jurisdiction constitutes explicit authorization for complainants to waive those protections."\textsuperscript{256} In the Court's language, and indeed in the construction of subsection 22(a), it is the \textit{choice} of "the complainant" to waive the protections and if waiver does occur, it occurs \textit{after} the cause of action arises.

By contrast, in predispute agreements, waiver is made \textit{prior} to any action arising at a time when, according to \textit{Wilko}, the investor "is less able to judge the weight of the handicap the Securities Act places upon his adversary."\textsuperscript{257} Additionally, it can be argued that waiver is not necessarily voluntary by virtue of the unequal bargaining power between the investor and industry personnel.\textsuperscript{258} It was just this problem — unequal bargaining power — that \textit{Wilko} noted as the purpose that the Securities Act was designed to address.\textsuperscript{259} However, even if predispute agreements were made

\begin{itemize}
\item \textsuperscript{253} See statutes cited \textit{supra} notes 19 and 37.
\item \textsuperscript{254} \textit{Wilko}, 346 U.S. at 435.
\item \textsuperscript{255} \textit{Rodriguez}, ___ U.S. at ___, 109 S. Ct. at 1920.
\item \textsuperscript{256} \textit{Id.}
\item \textsuperscript{257} \textit{Wilko}, 346 U.S. at 435.
\item \textsuperscript{258} \textit{Id.}; \textit{see also supra} note 205 and accompanying text describing Congress' concern with mandatory agreements. States have also become concerned with this issue. For example, Massachusetts passed regulations barring broker-dealers from including mandatory arbitration clauses in their customer agreements. Securities Indus. Ass'n v. Connolly, 703 F. Supp. 146 (D. Mass. 1988). The law was struck down before it became effective. \textit{Id.} The Securities Industry Association filed suit and successfully challenged the regulation on the constitutionality of the prospective security arbitration regulations. \textit{Id.}
\item \textsuperscript{259} \textit{Wilko}, 346 U.S. at 435.
\end{itemize}
voluntary in all situations, this would be irrelevant to the original reading of Wilko, as it is congressional intent, not the status or fairness of the arbitral process, that is relevant. In addition, the waiver of the right to a judicial forum before the cause of action arises, even if voluntary, is antithetical to the purpose of the Act — the protection of investors. Ensuring the voluntariness of these agreements only addresses one part of the policy of investor protection — equality in negotiating or bargaining power. It does not, however, address another concern regarding the lack of sophistication that investors have in general about securities and the consequences which flow from their decisions.

Finally, the Rodriguez Court stated that these procedural provisions can be waived because the federal statutes have these same provisions, and they have not been interpreted to prohibit enforcement of predispute agreements to arbitrate. This kind of logic again attempts to treat all federal statutes the same.

D. The Problem with Sections 14 and 29 Being Given the Same Interpretation

The Rodriguez Court’s next argument was that Section 14 should be given the same interpretation as Section 29 since the wording of these statutes is essentially the same. This argument rests on two presumptions: (1) The McMahon Court was correct in finding that the Wilko Court erred in its reading of Section 14 (in applying it to remedy provisions); and (2) the difference between the jurisdictional sections in the two acts is not sufficient to militate against Section 14 being read to mean the same as subsection 29(a).

The Court argued that the only conceivable difference between the two acts, that of the concurrent jurisdiction, actually served “to advance the objective of allowing buyers of securities a broader right to select the forum for resolving disputes. . . .” The Court’s argument again presupposes that the selection of the arbitral forum is at the option of the buyer, and ignores the importance of the time when the option occurs — before the cause of action commences. Additionally, the Court revealed that the selection of a forum was a “right.” The Court itself has acknowledged the

261. See supra note 248 and accompanying text.
263. Id.
264. See supra notes 257-59 and accompanying text.
importance of this right. A right, however, can be maintained only if it is freely exercisable.

E. An Unfair Burden

In support of the Court's argument that the investors did not carry their burden of showing congressional intent to remove their claim from the Arbitration Act, the Rodriguez Court cited Justice Frankfurter's dissent in Wilko. This signifies that the Court believed that the plaintiff only satisfies the burden if he shows that the arbitral system was deficient in protecting his rights. This further indicates that the Court held that the status of the arbitration process dictates congressional intent, instead of the other way around.

Further, using the language in Wilko, the Court reasoned that Section 2 of the Arbitration Act, which gives relief against arbitration agreements that are a result of "fraud or overreaching economic power," serves to protect buyers of securities by removing "the disadvantages under which buyers labor." The Rodriguez Court argued that the fraud and overreaching defenses advance the concept of investor protection in the Act. The Wilko language, however, is incorrectly applied. The language was used in Wilko to prove that congressional intent denied an arbitral forum altogether. It was not used as a means of providing an exception from arbitration in certain cases. If the Court refuses to remove Securities Act claims from the Arbitration Act, then the only recourse that the investor has is the grounds of revocation of the contract, fraud or overreaching de-

265. The Supreme Court has recognized that the choice of forum can have a dramatic effect on the scope of the rights to be interpreted and enforced. See Alexander v. Gardner-Denver Co., 415 U.S. 36, 56 (1974) ("the choice of forums inevitably affects the scope of the substantive right to be vindicated") (citing United States Bulk Carriers, Inc. v. Arguelles, 400 U.S. 351, 359-60 (1971) (Harlan, J., concurring)); Bernhardt v. Polygraphic Co. of Am., 350 U.S. 198, 203 (1956). The Bernhardt Court stated that:

[a]rbitration, whatever its merits or shortcomings, substantially affects the cause of action created by the State. The nature of the tribunal where suits are tried is an important part of the parcel of rights behind a cause of action. The change from a court of law to an arbitration panel may make a radical difference in ultimate result.

Id.


267. Id. (quoting Mitsubishi Motor Corp. v. Soler Chrysler-Plymouth, 473 U.S. 614, 627 (1985)).

268. Id. (citing Wilko, 346 U.S. at 435) (noting that there was nothing in the record of Rodriguez to indicate that the agreement to arbitrate would not offer the plaintiff the rights to which he was entitled).
fenses. These defenses, however, are generally not successful.\textsuperscript{269} This occurs at a time when even the SEC has expressed some concern about mandatory arbitration agreements and buyer protection.\textsuperscript{270} The policy of buyer protection is, therefore, arguably not advanced by Section 2 of the Arbitration Act.

In 1988, Commissioner David Ruder of the SEC testified before Congress that there were serious concerns with the use of predispute arbitration agreements.\textsuperscript{271} He noted that there was a growing trend toward making these agreements a condition of doing business with a securities firm.\textsuperscript{272} Ruder also stated that this was particularly disturbing in connection with cash accounts where "choice" should be maintained.\textsuperscript{273} Additionally, Ruder noted that the use of such agreements in margin accounts and option accounts needed further examination because issues concerning margin and option accounts such as fiduciary responsibility and customer suitability are particularly complicated, and do not lend themselves to an easy solution.\textsuperscript{274} He further stated that with respect to all accounts, it is apparent that many customers are not provided with clear and informative disclosure of either the existence or meaning of predispute arbitration clauses.\textsuperscript{275} Finally, Ruder noted that the content of these clauses must be regulated in order to prevent brokers "from using their economic power to limit investors' rights."\textsuperscript{276}

**VII. SUMMARY**

Following the *Rodriguez* decision, the SEC approved a number of proposed recommendations made by SROs that were intended to improve industry arbitration programs. Among other things, these recommendations provide for: the development and dissemination of a standardized award summary; the preservation of a written record of proceedings; a more com-

\begin{itemize}
\item \textsuperscript{269} For a discussion regarding the lack of success of these defenses, see Roth, *Developments in Securities Industry Arbitration*, PLI CONFERENCE REPORT 789, 807-08 (Oct. 17, 1988). "Customers frequently argue that compelled arbitration is unenforceable as unconscionable, either on the theory that they were fraudulently induced to accept the arbitration clause or that the arbitration provision is an unenforceable contract of adhesion. Neither argument generally succeeds." Id.
\item \textsuperscript{270} See Statement of David S. Ruder, Chairman of the Securities and Exchange Commission, before the Subcommittee on Telecommunication and Finance of the House Committee on Energy and Commerce. PLI CONFERENCE REPORT 837 (July 11, 1988).
\item \textsuperscript{271} Id. at 849.
\item \textsuperscript{272} Id. at 848.
\item \textsuperscript{273} Id. at 849.
\item \textsuperscript{274} Id. at 853.
\item \textsuperscript{275} Id. at 852.
\item \textsuperscript{276} Id.
complete disclosure of the rights customers waive under predispute arbitration claims; additional procedures to resolve discovery disputes; and a revision of the criteria for defining public and industry arbitrations. In reviewing these revisions, as well as the current status of the arbitration process, the question remains the same — is the purpose of investor protection under the securities laws advanced?

If one is to accept the premise that Rodriguez was decided incorrectly and it was Congress’ original intent that the judiciary be the only forum that can adequately protect buyers, then these additional revisions as well as any other attempts to improve the arbitral system, are irrelevant. If, however, Rodriguez was decided correctly, and the argument is accepted that an arbitral forum can be considered judicially equivalent in protecting investors, then arbitration procedures must be scrutinized thoroughly to see whether the promise of protection is delivered.

Severe problems in the arbitral process remain, however. Certainly the arbitral process is not the equivalent of the judicial process in form and does not pretend to be. Among other things, the full range of discovery procedures are not available, the review process is limited, the Federal Rules of Evidence are not applicable, and punitive damages generally are not awarded.

It is also questionable whether the arbitral process in substance can advance investor protection to the same extent as the judicial process. Despite recent revisions to the arbitration process to increase procedural protection, there are still major questions of fairness. It is still not mandatory that arbitral opinions be written or required that the reason for the decision be disclosed. The opportunity for review is thus limited. Additionally, a mistake of law is not currently grounds for vacating an arbitration award. This is especially alarming when there is no requirement that arbitrators be instructed or educated in the law. As a result, arbitrators may misconstrue the legal meaning of such basic and crucial statutory terms as “reasonable care,” “material facts” or “burden of proof.” The end result may be a decision based on the erroneous application of the law with little or no chance of review.

Besides problems with arbitral procedures, the arbitration process may be becoming more coercive than voluntary. It is commonly known that many brokerage firms now are making it clear to clients that services will not be provided unless the client agrees to predispute arbitration clauses. For example, some large firms not only require customers to agree to com-

pulsory arbitration but they liquidate the accounts of those who refuse. Most of the accounts affected are either option or margin accounts; however 39%-60% are cash accounts. This affects a good many investors.

With all of this in mind, an argument can be made that investors are not protected to the extent that they are in the judicial process, particularly when they are forced into predispute agreements as a result of their lack of equal bargaining power and are faced with limited procedures to address and review their claims. Proponents of arbitration argue that more procedures can be effectuated to right current inequities, but even so, the basic features of arbitration — efficiency and lack of formality — necessarily limit attempts to cloak the process with the protections that a judicial forum can provide. Additionally, if more laws and regulations are passed, the arbitral process will lose the unique advantages it provides. In light of this, the bottomline question becomes whether the inherent differences in the arbitral process defeat the policy of investor protection to such an extent that the purpose of the securities laws are not upheld. One can argue that the slightest erosion of investor protection is enough to result in an answer in the affirmative. If so, then the original interpretation of Wilko is correct in concluding that only a judicial forum can fully protect investors.
