TAKE IT OR LEAVE IT: UNCONSCIONABILITY OF MANDATORY PRE-DISPUTE ARBITRATION AGREEMENTS IN THE SECURITIES INDUSTRY

William Alan Nelson II, J.D., LL.M.*

* Professorial Lecturer in Law, George Washington University Law School; Public Policy Counsel, Certified Financial Planner Board of Standards, Inc. (CFP Board). The views and opinions expressed in this Article are solely those of the author and do not necessarily represent the views and opinions of, and should not be attributed to, the CFP Board. I would like to thank the University of Pennsylvania Journal of Business Law editorial staff for their dedication in readying the Article for publication. I would also like to dedicate this Article to my beautiful wife Emily, whose constant love, support, and encouragement have sustained me beyond measure.

INTRODUCTION

"Counsel's argument that the parties voluntarily agreed to arbitration and that the process saves money is also disingenuous. . . . [I]ndividuals have no recourse but to agree to an arbitration clause. Further, since the individuals seldom win and are forced to reimburse costs and attorney fees, the only ones saving money are large institutions like the claimant."[1]

The pervasive use of mandatory pre-dispute arbitration agreements ("PDAAs") in the securities industry is a relatively new phenomenon. Beginning in the 1980s, the Supreme Court announced that federal statutory rights, specifically claims arising under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"), are subject to arbitration unless Congress has evinced a contrary intent.[2] An overwhelming majority of retail brokerage and many investment advisory agreements include language requiring all disputes between the customer and broker-dealer/investment adviser be resolved through arbitration[3]—most often with Financial Industry Regulatory

1. Wells Fargo Advisors, LLC v. Watts, 858 F. Supp. 2d 591, 595 (W.D.N.C. 2012).

2. *See, e.g.*, Shearson/Am. Express v. McMahon, 482 U.S. 220 (1987) (holding that claims under a certain provision of the Securities Exchange Act were arbitrable under pre-dispute arbitration agreements, and that agreements to arbitrate these claims are enforceable because customers could effectively vindicate their claims against broker in arbitral forum).

3. Luis A. Aguilar, Comm'r, Sec. & Exch. Comm'n ("SEC"), Speech before the North American Securities Administrators Association ("NASAA") Annual NASAA/SEC 19(d) Conference: Outmanned and Outgunned: Fighting on Behalf of Investors Despite

Authority ("FINRA") Dispute Resolution. Thus, only in rare instances can an investor open a brokerage or investment advisory account without agreeing to submit to mandatory pre-dispute arbitration.

This Article begins by discussing the jurisprudence of mandatory PDAAs in the securities industry, including the legality of forcing investors to waive access to class action lawsuits. The Article then transitions into a discussion of the arguments against the use of mandatory PDAAs, including the Supreme Court invention of a "pro-arbitration" policy and the adhesive nature of brokerage and advisory contracts. The Article then argues that mandatory PDAAs are *per se* unconscionable because they require investors to involuntarily waive certain constitutional rights and provide narrow appellate avenues that effectively preclude judicial review of arbitral awards. The Article concludes by providing an example of a mandatory PDAA reflecting the current legal regime governing arbitration and possible solutions for policy-makers—the most appropriate of which is to prohibit the use of mandatory PDAAs in the securities industry.

This topic is timely, especially since FINRA recently enforced a $500,000 fine on Charles Schwab & Co. for using a mandatory PDAA in contravention of FINRA rules. There has also been heightened Congressional interest in the issue, evidenced by a bill proposed by Representative Keith Ellison in the House of Representatives in 2013[4] and a recent Senate Financial Committee report citing mandatory pre-dispute arbitration agreements as a critical issue for the SEC to investigate.[5]

The use of mandatory arbitration agreements has harmed thousands of investors over the past twenty years. A June 2007 study of more than 14,000 FINRA arbitration awards over a ten-year period (1995—2004) found that investors with significant claims suing major brokerage firms could expect to recover only *twelve percent* of the amount claimed.[6] In a

Efforts to Weaken Investor Protections (Apr. 16, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1365171515400#.UfmMlZWdzdk ("Currently, almost all customer agreements with brokerage firms include an arbitration clause requiring customers to arbitrate their claims in an arbitration forum—and they're now popping-up in the investment advisory industry.").

4. Investor Choice Act of 2013, H.R. 2998, 113th Cong. (2013).

5. STAFF OF S. COMM. ON APPROPRIATIONS, 113TH CONG., FY 2015 FINANCIAL SERVICES AND GENERAL GOVERNMENT APPROPRIATIONS BILL (Comm. Print 2014), *available at* http://www.appropriations.senate.gov/sites/default/files/FSGG%20Report%20w%20Chart% 2003REPT.PDF.

6. *See* EDWARD S. O'NEAL & DANIEL R. SOLIN, SEC. LITIG. & CONSULTING GRP., MANDATORY ARBITRATION OF SECURITIES DISPUTES: A STATISTICAL ANALYSIS OF HOW CLAIMANTS FARE 15 (2007), *available at* http://slcg.com/pdf/workingpapers/ Mandatory%20Arbitration%20Study.pdf (emphasis added) (finding a recovery percentage of just 12 percent when the claimant sought over $250,000 against one of the top twenty brokerage firms).

2008 survey of over 3,000 individuals who participated in an arbitration (e.g., investors, advisors, attorneys), seventy-one percent of investors were dissatisfied with the outcome of the arbitration.[7] Even with these chilling figures, it is important to note that arbitration is a proper dispute resolution process for some investors; however, individual investors should be permitted to make that choice.

I. JURISPRUDENCE OF MANDATORY PRE-DISPUTE ARBITRATION AGREEMENTS IN THE SECURITIES INDUSTRY

Even though the pervasive use of mandatory PDAAs has only arisen in the last thirty years, the issue of the legality of mandatory PDAAs stretches back to the 1950s. This Section will demonstrate the Supreme Court's evolution on the issue of mandatory PDAAs, illustrate the current view of the Supreme Court on how these agreements are enforced, and analyze recent developments concerning the use of class action waivers in mandatory PDAAs.

A. Enforceability in Brokerage and Advisory Contracts

1. Wilko v. Swan

In the Supreme Court's 1953 decision, *Wilko v. Swan*,[8] a customer brought an action against a securities brokerage firm to recover damages under Section 12(a)(2) of the Securities Act of 1933[9] for alleged misrepresentation in the sale of securities. The brokerage contract between

7. Jill I. Gross & Barbara Black, *When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration*, 2008 J. DISP. RESOL. 349, 386 (2008).

8. 346 U.S. 427 (1953).

9. *See* Securities Act of 1933 § 12(a)(2), 15 U.S.C. § 77l(a)(2) (2006 & Supp. V 2011) ("Any person who . . . sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraphs (2) and (14) of subsection (a) of said section), 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, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.").

the investor and broker contained a mandatory PDAA.[10] Based upon the language of the contract, the broker moved to stay the trial of the action pursuant to Section 3 of the Federal Arbitration Act (FAA)[11] until an arbitration, in accordance with the terms of the contract, was had.[12]

The district court held that "the agreement to arbitrate deprived [the investor] of the advantageous court remedy afforded by the Securities Act, and denied the stay."[13] A divided Second Circuit concluded that the Securities Act "did not prohibit the agreement to refer future controversies to arbitration, and reversed."[14] The case was subsequently taken up by the Supreme Court.

Before beginning its analysis, the Supreme Court noted that because the contract between the investor and broker evidenced a transaction in interstate commerce, there was no issue as to the applicability of the provisions of the FAA to the lawsuit.[15] The Supreme Court looked at the question of "whether an agreement to arbitrate a future controversy is a 'condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision' of the Securities Act which § 14 declares 'void.'"[16]

The Supreme Court held that Section 14 of the Securities Act voids any "'stipulation' waiving compliance with any 'provision' of the Securities Act" and that the agreement to arbitrate was "a 'stipulation' and . . . the right to select the judicial forum is the kind of 'provision' that cannot be waived under [Section] 14 of the Securities Act."[17] The Supreme Court couched this decision in terms of investor protection, specifically stating:

10. *Wilko*, 346 U.S. at 429.

11. *See* 9 U.S.C. § 3 (2012 & Supp. I 2013) ("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, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.").

12. *Wilko*, 346 U.S. at 429.

13. *Id.* at 430.

14. *Id.*

15. *Id.*

16. *Id.* (citing Securities Act of 1933 § 14, 15 U.S.C. § 77n (2012 & Supp. I 2013)). Section 14 of the Securities Act states that "[a]ny 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.

17. *Id.* at 434–35.

> 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.[18]

2. Scherk v. Alberto-Culver

The Supreme Court revisited this issue over two decades later in 1974 in *Scherk v. Alberto-Culver Co.* In *Scherk v. Alberto-Culver Co.*,[19] Franz Scherk, a German businessman, sold his trademarks and interest in a European toiletries business to Alberto-Culver, Co., a U.S. corporation.[20] Approximately one year after the sale, Alberto-Culver tendered the property back to Scherk, because the trademarks were subject to substantial encumbrances that threatened to restrict Alberto-Culver's use of them.[21] When Scherk refused to rescind the contract, Alberto-Culver sued Scherk in federal court in Illinois.[22] Scherk subsequently filed a motion to dismiss based upon an arbitration clause in the contract of sale that provided that "'any controversy or claim [that] shall arise out of this agreement or the breach thereof' would be referred to arbitration before the International Chamber of Commerce in Paris, France."[23]

The U.S. District Court for the District of Illinois, relying on the Supreme Court's decision in *Wilko v. Swan*, denied Scherk's motion to dismiss and "granted a preliminary order enjoining Scherk from proceeding with arbitration."[24] The Seventh Circuit, similarly relying on *Wilko v. Swan*, affirmed the District Court's decision.[25] The Supreme Court granted certiorari to review the question of whether an arbitration agreement contained in an international sales contract was enforceable.

The Supreme Court reversed the Seventh Circuit's decision.[26] The Supreme Court first looked at whether the *Wilko* reasoning applied to the case at bar. The Court looked at both the Securities Act and the Securities

18. *Id.* at 435.
19. 417 U.S. 506 (1974).
20. *Id.* at 508.
21. *Id.*
22. *Id.*
23. *Id.*
24. *Id.* at 510.
25. *Id.*
26. *Id.* at 513.

Exchange Act of 1934 (Exchange Act) and found that there was no statutory counterpart for the Section 12(a)(2) action brought by the plaintiff in *Wilko*.[27] The Court then discussed how even if there was a statutory counterpart in the Exchange Act, the international business contract at issue involved considerations and policies significantly different than those found controlling in *Wilko*.[28] The Court found that "[a] contractual provision specifying in advance the forum in which disputes shall be litigated and the law to be applied is, therefore, an almost indispensable precondition to achievement of the orderliness and predictability essential to any international business transaction."[29]

The Supreme Court relied on the international nature of the contract at issue in *Scherk* to enforce the arbitration agreement. The Court was careful, though, to make clear that the decision "has no bearing on the scope of the substantive provisions of the federal securities laws [because] that . . . question is not presented in this case."[30]

3. Shearson/American Express v. McMahon

The Supreme Court revisited this issue again over a decade later in 1987 in *Shearson/American Express v. McMahon*. In *Shearson/American Express v. McMahon*,[31] customers brought an action against a securities brokerage firm claiming that the firm violated Section 10(b) of the Exchange Act by making fraudulent and excessive trades on the customers' accounts, making false statements, and omitting material facts from advice given to customers.[32] The contract between the customers and brokerage firm contained a mandatory PDAA. Based upon the language of the contract, the brokerage firm moved to stay the trial of the action pursuant to Section 3 of the FAA until an arbitration in accordance with the terms of the contract was conducted[33]

The U.S. District Court for the Southern District of New York first found that the brokerage agreement between the customers and the firm were not contracts of adhesion.[34] The District Court, relying on *Dean Witter Reynolds Inc. v. Byrd*[35] and the "'strong national policy favoring the enforcement of arbitration agreements,'" held that the customers' Section

27. *Id.* at 513.
28. *Id.* at 515–16.
29. *Id.* at 516.
30. *Id.* at 518 n.12.
31. 482 U.S. 220 (1987).
32. *Id.* at 223.
33. *Id.* at 223–24.
34. *Id.*
35. 470 U.S. 213 (1985).

10(b) claims were arbitrable under the terms of the agreement.[36] The Second Circuit, relying on *Wilko v. Swan*, reversed the District Court's decision concerning the Exchange Act claims.[37] The Supreme Court granted certiorari to resolve the circuit split regarding the arbitrability of Exchange Act claims.

The Supreme Court reversed the Second Circuit's decision with regard to the Exchange Act claims. The Supreme Court opened with the statement that the FAA established a "'federal policy favoring arbitration'" and that the Court should "'rigorously enforce agreements to arbitrate.'"[38] The Court focused on its previous decision in *Wilko* and held that "[w]hile stare decisis concerns may counsel against upsetting *Wilko's* contrary conclusion under the Securities Act, we refuse to extend *Wilko's* reasoning to the Exchange Act in light of these intervening regulatory developments."[39] The regulatory developments cited by the Court included the competence of arbitral panels to decide securities claims and the expansive power and authority that the SEC has over the arbitral proceedings.[40] The Court concluded its decision with its interpretation of Congress's intent:

> Congress did not intend for [Section] 29(a) to bar enforcement of all predispute arbitration agreements. In this case, where the SEC has sufficient statutory authority to ensure that arbitration is adequate to vindicate Exchange Act rights, enforcement does not effect a waiver of 'compliance with any provision' of the Exchange Act under [Section] 29(a).[41]

4. Rodriguez de Quijas v. Shearson/American Express, Inc.

In the Supreme Court's 1989 decision, *Rodriguez de Quijas v. Shearson/American Express, Inc.*,[42] investors brought an action against a securities brokerage firm to recover damages under Section 12(2) of the Securities Act[43] for alleged misrepresentation in the sale of securities.[44]

36. *Shearson*, 482 U.S. at 224.

37. *Id.*

38. *Id.* at 226 (quoting Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983) and Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 221 (1985)).

39. *Id.* at 234.

40. 17 CFR § 240.19b–4. As part of the SEC's oversight of FINRA, FINRA must seek approval from the SEC to amend existing rules or implement new rules, including rules governing arbitration.

41. *Id.* at 238.

42. 490 U.S. 477 (1989).

43. Securities Act of 1933 § 12(2), 15 U.S.C. § 77l(2) (2006 & Supp. V 2011).

The contract between the investor and broker contained a mandatory PDAA. Based upon the language of the contract, the broker moved to stay the trial of the action pursuant to Section 3 of the Federal Arbitration Act until an arbitration in accordance with the terms of the contract was had.[45]

The "District Court ordered all the claims to be submitted to arbitration except for those raised under [Section] 12(2) of the Securities Act."[46] It held that the Securities Act claims must proceed in the court under the Supreme Court's holding in *Wilko*.[47] The Fifth Circuit reversed, concluding that the arbitration agreement is enforceable because "[the Supreme] Court's subsequent decisions have reduced *Wilko* to 'obsolescence.'"[48] The Supreme Court granted certiorari to resolve the conflict among the circuit courts regarding the arbitrability of Securities Act claims.

The Supreme Court affirmed the Fifth Circuit's decision with regard to the Securities Act claims. The Court looked at *McMahon*, which "declined to read [Section] 29(a) of the Securities Exchange Act of 1934, the language of which is in every respect the same as that in [Section] 14 of the 1933 Act . . . to prohibit enforcement of predispute agreements to arbitrate."[49] The Court focused on its "pro-arbitration policy" by finding that "the party opposing arbitration carries the burden of showing that Congress intended in a separate statute to preclude a waiver of judicial remedies, or that such a waiver of judicial remedies inherently conflicts with the underlying purposes of that other statute."[50] And, relying on the dissent in *Wilko*, held 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.'"[51] The Court concluded by specifically holding that "*Wilko* was incorrectly decided and is inconsistent with the prevailing uniform construction of other federal statutes governing arbitration agreements in the setting of business transactions."[52]

The importance of the decisions in *McMahon* and *Rodriguez de Quijas* cannot be underestimated. The decisions reversed the Supreme Court's previous decision in *Wilko* and 32 years of lower court decisions relying on *Wilko*, which had deemed Securities Act and Exchange Act

44. *Rodriguez*, 490 U.S. at 478–79.
45. *Id.* at 479.
46. *Id.*
47. *Id.*
48. *Id.*
49. *Id.* at 482.
50. *Id.* at 483.
51. *Id.* (quoting *Wilko*, 346 U.S. at 439 (Frankfurter, J., dissenting)).
52. *Id.* at 484.

claims not arbitrable. These decisions also signify the first time the Supreme Court interjected its "pro-arbitration" policy into a securities law decision. This policy will be discussed in further detail later in the Article.

B. Legality of Class Action Waiver Provisions

The Supreme Court has effectively ruled that companies may include class action waiver provisions in their brokerage and advisory contracts.[53] The Supreme Court's recent allowance of class action waivers deviates from prior holdings that touted the merits of class action lawsuits.[54] Additionally, FINRA recently opposed the Supreme Court's allowance of class action waivers and fined one of its members for using it in a brokerage contract.

1. AT&T Mobility, LLC v. Concepcion

In *Concepcion*, customers who entered into a contract with AT&T brought a class action suit alleging fraud and false advertising in connection with the carrier's advertising practices.[55] The customer contract provided for "arbitration of all disputes between the parties, but required that claims be brought in the parties' 'individual capacity, and not as a plaintiff or class member in any purported class or representative proceeding.'"[56] AT&T moved to compel arbitration, citing the mandatory arbitration agreement in its customer contract that prohibited class actions.[57] The district court denied AT&T's motion and held that the mandatory arbitration provision was unconscionable because AT&T had failed to demonstrate that the provision "adequately substituted for the deterrent effects of class actions."[58] The Ninth Circuit affirmed, holding that the class action waiver provision was unconscionable and that the California rule was not preempted by the FAA because it was "'a

53. *See, e.g.*, AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740 (2011) (holding that the FAA preempted a California law that would have invalidated an arbitration clause containing a class action waiver).

54. Amchem Prods., Inc. v. Windsor, 521 U.S. 591, 617 (1997) (quoting Mace v. Van Ru Credit Corp., 109 F.3d 338, 344 (7th Cir. 1997) ("The policy at the very core of the class action mechanism is to overcome the problem that small recoveries do not provide the incentive for any individual to bring a solo action prosecuting his or her rights.").

55. *Concepcion*, 131 S. Ct. at 1744.

56. *Id.*

57. *Id.* at 1745.

58. *Id.* (citing Laster v. T-Mobile USA, Inc., 2008 WL 5216255, at *14 (S.D. Cal. Aug. 11, 2008)).

refinement of the unconscionability analysis applicable to contracts generally in California.'"[59]

The Supreme Court, in a divided 5—4 decision, reversed the Ninth Circuit's holding, finding that the FAA preempted state law that operated to invalidate a contractual arbitration provision. Specifically, the Supreme Court held that because the rule had been routinely applied by California courts to invalidate arbitration agreements in adhesion contracts, the rule stood as "'an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'"[60]

2. American Express Co. v. Italian Colors Restaurant

In *Italian Colors*, the plaintiffs were merchants who accepted American Express charge cards and credit cards pursuant to contracts with American Express.[61] They alleged that American Express violated the federal antitrust laws by forcing them to accept American Express credit cards at interchange rates for merchants that were approximately 30 percent higher than the rates for competing credit cards.[62] The business contract contained "a clause that requires all disputes between the parties to be resolved by arbitration. The agreement also provide[d] that '[t]here shall be no right or authority for any [c]laims to be arbitrated on a class action basis.'"[63] The District Court granted the motion of American Express to compel individual arbitration.[64] The Second Circuit reversed and remanded for further proceedings, holding that "because respondents had established that 'they would incur prohibitive costs if compelled to arbitrate under the class action waiver,' the waiver was unenforceable and the arbitration could not proceed."[65]

The Supreme Court, in a 5—3 decision, held that a waiver of class arbitration was enforceable under the FAA, even if the plaintiffs' costs of individually arbitrating their antitrust claims exceeded the potential recovery for each plaintiff.[66] The Supreme Court specifically held that "the fact that it is not worth the expense involved in *proving* a statutory remedy does not constitute the elimination of the *right to pursue* that remedy" and

59. *Id.* (quoting Laster v. AT&T Mobility LLC, 584 F.3d 849, 857 (9th Cir. 2009)).
60. *Id.* at 1753 (quoting Hines v. Davidowitz, 312 U.S. 52, 67 (1941)).
61. Am. Express Co. v. Italian Colors Rest., 133 S. Ct. 2304 (2013).
62. *Id.* at 2308.
63. *Id.*
64. *Id.*
65. *Id.* (quoting *In re* Am. Express Merchs. Litig., 554 F.3d 300, 315–16 (2d Cir. 2009)).
66. *Id.* at 2311.

that the Court's previous decision in *Concepcion* "all but resolve[d] this case."[67]

3. FINRA v. Schwab

In February 2012, FINRA, which is an independent, not-for-profit organization authorized by Congress to regulate securities firms and associated persons who do business with the public, brought a disciplinary action[68] against Charles Schwab & Co., a brokerage and banking company.[69] The first cause of action alleged that Schwab, by placing a class-action waiver in its customer agreements and attempting to limit customers' ability to bring or participate in class actions, violated FINRA Rule 2268(d)(3)[70] and FINRA Code of Arbitration Procedure for Customer Disputes ("FINRA Customer Code") Rule 12204(d).[71] These regulations concern a firm's ability to use a pre-dispute arbitration agreement to limit or contradict FINRA rules and enforce a class action waiver provision in its contract.

FINRA takes disciplinary action through issuance of a formal complaint. When a complaint is issued, the case is heard before a Hearing Panel that is chaired by a professional hearing officer and includes two industry representatives.[72] A firm or individual can appeal a Hearing Panel decision to FINRA's National Adjudicatory Council (NAC), a body that is

---

67. *Id.* at 2312 (emphasis in original).

68. The Complaint was filed with the FINRA Office of Hearing Officers.

69. Dep't. of Enforcement v. Charles Schwab & Co., Inc., Disciplinary Proceeding No. 2011029760201 (FINRA Office of Hearing Officers Feb. 21, 2013), at 3, *available at* http://www.finra.org/web/groups/industry/documents/ohodecisions/p258285.pdf.).

70. FINRA Rule 2268(d)(1) states that "[n]o predispute arbitration agreement shall include any condition that . . . limits or contradicts the rules of any self-regulatory organization . . . ." FINRA RULE 2268(d)(1), FINRA MANUAL: DUTIES & CONFLICTS., FIN. INDUS. REGULATORY AUTH. (as amended in 2011), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9955&filtered_tag=

71. FINRA Customer Code Rule 12204(d) states that:

> [a] member or associated person may not enforce any arbitration agreement against a member of a certified or putative class action with respect to any claim that is the subject of the certified or putative class action until: [(1)] [t]he class certification is denied; [(2)] [t]he class is decertified; [(3)] [t]he member of the certified or putative class is excluded from the class by the court; or [(4)] [t]he member of the certified or putative class elects not to participate in the class or withdraws from the class according to conditions set by the court, if any.

FINRA RULE 12204(d), FINRA MANUAL: CODE OF ARBITRATION PROCEDURE FOR CUSTOMER DISPUTES, FIN. INDUS. REGULATORY AUTH. (as amended in 2008), *available at* http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=4096&record_id=5174&filtered_tag=

72. *Adjudication*, FIN. INDUS. REGULATORY AUTH., *available at* http://www.finra.org/Industry/Enforcement/Adjudication/ (last visited Mar. 5, 2015).

equally balanced between individuals who are in the securities business and non-industry representatives. FINRA's Board of Governors can decide whether or not to review the NAC's decision; if there is no review, the NAC decision is FINRA's final action in the matter. A firm or individual can appeal FINRA's final decision to the SEC and then to a federal court.[73]

The Hearing Panel issued its decision in February 2013.[74] The Hearing Panel's decision concentrated primarily on two issues: (1) whether Schwab's waiver conflicts with FINRA rules, and (2), if so, whether the FAA preempts FINRA rules. The Hearing Panel found that both FINRA Rules 2268(d)(1) and (d)(3), acting in conjunction with Rule 12204 of the FINRA Customer Code, banned the use of class action waivers by FINRA members.[75] However, the Hearing Panel ultimately concluded that these Rules may not be enforced.[76] The Hearing Panel found that enforcement was foreclosed by the FAA, as construed by the Supreme Court in *Concepcion* and other decisions.[77] Because the Hearing Panel found no clear expression of congressional intent to preserve judicial class actions as an option for customer claims where there is an agreement providing for arbitration of those claims, the Hearing Panel granted Schwab's motion for summary disposition concerning the mandatory PDAA's class-action waiver provision.

Contemporaneously with the FINRA disciplinary action, Schwab filed a complaint for declaratory and preliminary and permanent injunctive relief against FINRA in the United States District Court for the Northern District of California.[78] "Schwab argued that FINRA Rule 2268(d), properly interpreted, does not prohibit class action waivers and, in the alternative, even if intended to do so, the rule's enforcement would impermissibly violate the FAA, as interpreted by the Supreme Court in *AT&T Mobility* . . . and *CompuCredit Corp. v. Greenwood*, 132 S. Ct. 665 (2012)."[79]

FINRA filed a motion to dismiss the complaint, arguing that the federal court lacked jurisdiction. On May 11, 2012, the district court

73. *Id.*

74. Dep't. of Enforcement v. Charles Schwab & Co., Inc., Disciplinary Proceeding No. 2011029760201 (FINRA Office of Hearing Officers Feb. 21, 2013), at 1, *available at* http://www.finra.org/web/groups/industry/documents/ohodecisions/p258285.pdf.

75. *Id.* at 23–24.

76. *Id.* at 40–41.

77. *Id.*

78. Charles Schwab & Co v. Fin. Indus. Regulatory Auth., 861 F. Supp. 2d 1063 (N.D. Cal. 2012).

79. Dep't of Enforcement v. Schwab, Disciplinary Proceeding No. 2011029760201 (FINRA Board of Governors Apr. 24, 2014), at 5 n.8, *available at* http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p493598.pdf [hereinafter Board of Governors Decision]; *Charles Schwab & Co*, 861 F. Supp. 2d at 1067.

granted FINRA's motion and dismissed Schwab's complaint. The court determined that it lacked subject matter jurisdiction because Schwab did not exhaust the administrative remedies established by the Exchange Act and that Schwab failed to show it was entitled to an exception from the general exhaustion requirement.[80]

This is an important procedural issue, because for any companies who want to challenge this type of disciplinary action, generally they must go through the administrative process before being able to utilize the judicial system. Many companies might find the burden cost inefficient and may just remove these provisions from their mandatory PDAAs.

The Board of Governors found that the two main issues regarding the enforceability of Schwab's pre-dispute arbitration agreements were: (1) whether FINRA rules preserve the right for investors to participate in judicial class actions and (2) whether the FAA applies to FINRA arbitration rules and preempts enforcement of those rules.[81]

The Board of Governors addressed these two issues in its decision and ultimately overruled the Hearing Panel decision, stating that:

> We uphold these FINRA rules and find that Schwab's inclusion of a mandatory waiver of participation in judicial class actions, as well as its restriction of an arbitrator's power to join together individual claims violates NASD and FINRA rules. Because we determine that the FAA does not preclude FINRA's enforcement of its rules, we reverse the Hearing Panel's dismissal of the first two causes of action. We remand this matter to the Hearing Panel to determine appropriate sanctions.[82]

In arriving at this decision, the Board of Governors first looked at the language of the rules in question (FINRA Rule 2268 and FINRA Customer Code Rule 12204). FINRA Rule 2268 sets the requirements for FINRA members when using pre-dispute arbitration agreements. Rule 2268(f) requires all pre-dispute arbitration agreements for customer accounts to state that no person may bring a class action in arbitration, nor seek to enforce a pre-dispute arbitration agreement against a person who has initiated a judicial class action or is a member of a putative class until class certification issues are decided.[83] The decision also focused on Rule

80. Board of Governors Decision, *supra* note 79, at 5 n.8; *Charles Schwab & Co*, 861 F. Supp. 2d at 1069.

81. Board of Governors Decision, *supra* note 79, at 3.

82. *Id.*

83. FINRA RULE 2268(f), FINRA MANUAL: DUTIES & CONFLICTS, FIN. INDUS. REGULATORY AUTH. (as amended in 2011), *available at* http://finra.complinet.com

2268(d)(3) which prohibits members from incorporating conditions in a pre-dispute arbitration agreement that "limit[] the ability of a party to file any claim in court permitted to be filed in court under the rules of the forums in which a claim may be filed under the agreement."[84]

Schwab argued that FINRA Rule 2268(d)(3) cannot be referring to class actions when the rule language uses the term "claim" because class actions are procedural mechanisms and not claims.[85] To determine the meaning of the word "claim", the Board of Governors turned to the definition set out in FINRA Customer Code Rule 12100(d), which defines a "claim" as "an allegation or request for relief."[86] Rule 12204 of the Customer Code is titled "Class Action Claims" and specifically addresses the status of class action claims in FINRA arbitration, stating that "[c]lass action claims may not be arbitrated under the [Customer] Code."[87]

The Board of Governors then proceeded to examine the rule-making history. It specifically focused on the intent behind Rule 12204 and found that the SEC stated "'in all cases, class actions are better handled by the courts and that investors should have access to the courts to resolve class actions efficiently'" and "[w]ithout access to class actions in appropriate cases, both investors and broker-dealers have been put to the expense of wasteful, duplicative litigation."[88]

The Board of Governors ultimately determined that "a securities-law claim brought as a class action therefore is a category of claim that was intended to be filed in court under FINRA rules."[89] The Board of Governors further determined that "Rule 12204 of the Customer Code was intended to preserve investor access to the courts to bring or participate in judicial class actions, and that through its Waiver, Schwab violated FINRA Rules 2268(d)(l) and (d)(3), and Rule 12204 of the Customer Code."[90]

Even though the Board of Governors found that there was a breach of its rules, they still had to determine whether the FAA pre-empted enforcement of those rules. As a threshold matter, the Board of Governors found that the FAA applied to the case because it governs virtually every

/en/display/display_main.html?rbid=2403&element_id=9955&filtered_tag=

84. FINRA RULE 2268(d)(3), FINRA MANUAL: DUTIES & CONFLICTS, FIN. INDUS. REGULATORY AUTH. (as amended in 2011), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9955&filtered_tag=

85. Board of Governors Decision, *supra* note 79, at 8.

86. *Id.* at 10.

87. *Id.*

88. *Id.* at 14 (quoting Order Approving Proposed Rule Change Relating to the Exclusion of Class Actions from Arbitration Proceedings, Exchange Act Release No. 31371, 1992 WL 324491, at *3).

89. *Id.* at 10

90. *Id.* at 15.

arbitration agreement arising out of a commercial transaction, and Schwab's customer transactions were no exception.[91] This decision first makes clear that even though there is a long-standing policy of favoring arbitration agreements, the FAA has limits. The Board of Governors cited *CompuCredit Corp. v. Greenwood*, where "the Supreme Court reaffirmed the principle that the mandate of the FAA is not absolute, explaining that it may be 'overridden by a contrary congressional command.'"[92]

To meet the standard under *Greenwood*, the decision specifically found that "both the text of the Exchange Act and the rulemaking history of NASD's proposal to adopt what are currently FINRA Rule 2268 and Rule 12204 of the Customer Code demonstrate a statutorily authorized intent to overcome the FAA."[93]

The Board of Governors looked at the Hearing Panel's determination that found no congressional intent to preserve judicial class actions as an option for customer claims under FINRA rules. They reversed the Hearing Panel and found that FINRA's authority to promulgate rules is a Congressional command.[94] The decision cited to *CompuCredit*, where the Supreme Court cited the Consumer Financial Protection Bureau's ("CFPB") authority to regulate predispute arbitration agreements as an example of a contrary congressional command. The Supreme Court found that "Congress both delegated to an agency and allowed the agency to exercise judgment. Consequently, we conclude that Congress's granting of authority to the SEC to approve of SRO limitations on arbitration agreements is equally as valid as its granting of authority to the CFPB."[95]

The Board of Governors then cited the Ninth Circuit's decision in *Credit Suisse First Boston Corp. v. Grunwald* for the proposition that "FINRA rules have the force and effect of a federal regulation for the

91. *Id.* at 16. They specifically noted that the Supreme Court had applied the FAA to securities arbitrations under the Exchange Act. *Id.*; *see* Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220 (1987) (indicating courts should favor enforcement of arbitration agreements).

92. Board of Governors Decision, *supra* note 79, at 18 (quoting CompuCredit Corp. v. Greenwood, 132 S. Ct. 665, 669 (2012)).

93. *Id.*

94. *Id.* at 20.

95. *Id.* at 20. "The Exchange Act manifestly gives FINRA the ability to propose, and the SEC the authority to approve, rules that govern which claims will be submitted to arbitration and which will not. The rulemaking history of FINRA's rules evidences that the SEC was approving FINRA's restrictions on predispute arbitration agreements pursuant to the Exchange Act. The SEC followed Congress's designated process for a FINRA rule to be approved. The Exchange Act's broad authorization encompassing FINRA arbitration rules that are approved by the SEC constitutes the Supreme Court's required congressional command to overcome the general mandate of the FAA to enforce arbitration agreements." *Id.* at 21.

purposes of resolving federal conflicts of law."[96] In *Grunwald*, the Ninth Circuit held that NASD's arbitration rules regarding disclosure and disqualification of arbitrators, which had been approved by the SEC, preempted conflicting state law requirements regarding arbitrators.[97] The Board of Governors surveyed other cases where conflicts existed between the antitrust laws and the securities laws, including SEC and FINRA rules, and found that securities laws prevailed when the Court determined that the antitrust laws would produce conflicting guidance in an area that is addressed by the securities laws.[98]

The Board of Governors reasoned that:

> [t]he Supreme Court's holdings that federal antitrust laws are impliedly repealed when they conflict with securities laws support the conclusion that the Exchange Act, effectuated through FINRA rules, overrides the FAA here. First, the SEC, through its oversight of the FINRA arbitration forum and its review of FINRA rules, has consistently exercised its authority to oversee the arbitration process. Second, the Schwab dispute represents a direct conflict between the FAA, which mandates enforcement of arbitration agreements according to their terms, and FINRA rules, which require broker dealers to preserve judicial class actions for investors. Third, FINRA's arbitration rules for customer disputes with FINRA firms and associated persons address a critical aspect of investor protection under the Exchange Act, namely in what forum a customer class action will be litigated. In reconciling the conflict between FINRA arbitration rules that prohibit use of a predispute arbitration agreement to eliminate judicial class actions and the FAA's enforcement of class action waivers, we find—based on the SEC's approval orders—that FINRA's rules are in furtherance of the Exchange Act's protection of investors. This core aspect of the Exchange Act prevails over the FAA.[99]

Schwab sought to use a series of recent Supreme Court opinions involving pre-dispute arbitration agreements between customers and

96. *Id.* at 21 (citing Credit Suisse First Boston Corp. v. Grunwald, 400 F.3d 1119, 1132 (9th Cir. 2005)).

97. *Id.* (citing *Grunwald*, 400 F.3d at 1132).

98. *Id.* (citing Gordon v. N.Y. Stock Exch., Inc., 422 U.S. 659 (1975); United States v. NASD, Inc., 422 U.S. 694 (1975)).

99. *Id.* at 22.

corporations to invalidate two of FINRA's longstanding arbitration rules.[100] However, after careful consideration, the Board of Governors found that FINRA's rules had not been invalidated by recent Supreme Court holdings related to pre-dispute arbitration agreements.[101] In so doing, the Board of Governors first looked at *Concepcion*, which involved a state law rule that invalidated class action waivers when one party had superior bargaining power and was alleged to have caused small damages to many customers.[102] FINRA held that "the line of cases in which courts have invalidated state laws based on federal preemption, however, do not apply to this case. FINRA arbitration rules are not creatures of state law nor should they be treated as equivalent to state law."[103]

The Board of Governors then looked at *American Express Co. v. Italian Colors Restaurant*, which reaffirmed that "the FAA 'requires the enforcement of arbitration agreements containing class action waivers' unless a law contains a contrary congressional command."[104] FINRA distinguished *Italian Colors* because, in that case, the Supreme Court found that "[p]redispute arbitration waivers that have the effect of making an individual party bear the expense of proving a violation . . . are valid and enforceable."[105] However, the Board of Governors found that *Italian Colors* did not apply to Schwab because there is no contention that customers must be allowed to pursue judicial class actions as a matter of efficiency.[106]

Schwab also relied on *McMahon*, which, as noted above, is the seminal case applying the FAA to securities arbitrations. Schwab contended that the holding in *McMahon*, that arbitration agreements were not invalid waivers of Exchange Act claims (those claims could be pursued in arbitration), mandates that class action waivers are valid.[107] But the Board of Governors found that the anti-waiver provision under the Exchange Act at issue in *McMahon* only prohibited a waiver of the substantive obligations imposed by the Exchange Act. The Board of Governors reasoned that "Rule 12204 of the Customer Code, in contrast, preserves investor access to the courts to bring or participate in judicial class actions. Schwab's class action waiver directly violates FINRA rules.

100. *Id.* at 23-24.
101. *Id.* at 23.
102. *See supra* Section II.B.1 (discussing the *AT&T Mobility* decision).
103. Board of Governors Decision, *supra* note 79, at 23.
104. *Id.* (quoting Am. Express Co. v. Italian Colors Rest., 133 S. Ct. 2304 (2013)).
105. *Id.* (citing *Italian Colors*, 133 S. Ct. at 2311).
106. *Id.* at 23–24.
107. *Id.* at 24.

It is not invalid because it requires a customer to waive a substantive obligation imposed by the Exchange Act."[108]

This decision has the ability to be a game-changer in the mandatory arbitration discussion. FINRA is asserting its authority to invalidate class action waivers in the mandatory PDAAs of its members. The fact that Schwab paid a $500,000 fine and waived its right to appeal the decision is very telling.[109] This large fine may deter other companies from placing class action waivers in their pre-dispute arbitration agreements.

It is important to note, however, that this is a decision made by FINRA, not a court of law. If a similar case rises to the courts, it will be much harder for plaintiffs to argue against enforcement of the class action waiver, due to the negative precedent set by *Concepcion*, *Italian Colors*, and the Supreme Court's long-standing policy favoring arbitration. This notion is reinforced by the recent decision in *Torres v. United Healthcare Servs., Inc.*, where a New York District Court found that the National Labor Relations Board's ("NLRB") interpretation of the FAA was outside its expertise and not entitled to deference.[110] Courts have also found that they are "not obligated to defer to an agency's interpretation of Supreme Court precedent under *Chevron* or any other principle."[111]

It is also important to note that this action was mainly brought about by customer complaints. Schwab admitted in news articles that:

> [o]ver the last year, we heard clearly that a number of our clients and members of the general public have strong feelings about maintaining access to class-action lawsuits. In a business like ours where our reputation and public trust are key to our success, we take perspectives like those very seriously.[112]

This Article contends that the reputational risk faced by companies will be more important than any judicial decision. This case helped confirm that principle. For example, even though both the FINRA Hearing Panel and courts allowed the class action waiver to be included in the pre-dispute arbitration agreement, investor complaints and bad publicity

108. *Id.* (quoting Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 228 (1987)).
109. *See id.* at 28. (detailing the sanctions imposed by FINRA's Board of Governors on Schwab).
110. Torres v. United Healthcare Servs., Inc., 920 F. Supp. 2d 368, 378 (E.D.N.Y. 2013).
111. N.Y. N.Y., LLC v. N.L.R.B., 313 F.3d 585, 590 (D.C. Cir. 2002).
112. Jed Horowitz & Suzanne Barlyn, *Schwab Drops Ban on Clients Filing Class-Action Lawsuits*, REUTERS, (Apr. 24, 2014), http://www.reuters.com/article/2014/04/24/schwab-classaction-settlement-idUSL2N0NG1XJ20140424.

ultimately caused Schwab to remove the provision, even if for a short period of time.

II. ARGUMENTS AGAINST MANDATORY PRE-DISPUTE ARBITRATION AGREEMENTS

This Article presents multiple arguments against the imposition of mandatory PDAAs in brokerage and advisory contracts including: (1) the Supreme Court's invention of a "pro-arbitration" policy; (2) involuntary relinquishment of certain Constitutional rights due to mandatory PDAAs; and (3) the lack of options available to investors to overturn an erroneous arbitration award effectively preclude judicial review.

A. Supreme Court Invention of a "Pro-Arbitration" Policy

As discussed in the cases in Section I, over the past thirty years the Supreme Court has developed the idea of a "pro-arbitration" policy.[113] Over the past three decades, the practice of using arbitration in lieu of litigation has not only garnered approval from the Supreme Court, but has been encouraged by the Court.[114] It is important to note the distinction between voluntary and mandatory arbitration. "While arbitration has been used as a dispute resolution technique for thousands of years, in the past it has been agreed to knowingly and voluntarily, typically by two or more businesses. The involuntary imposition of arbitration in lieu of open court procedures is a new and most controversial phenomenon."[115]

In its 1982 decision in *Moses H. Cone*, the Supreme Court stated that the FAA was a "congressional declaration of a liberal federal policy favoring arbitration agreements, notwithstanding any state substantive or procedural policies to the contrary."[116] This was the first instance in which the Supreme Court enunciated a federal policy that favors arbitration of commercial disputes. This statement by the Court, and subsequent holdings in *McMahon* and *Rodriguez de Quijas*, have provided businesses the opportunity to compel arbitration in contexts where they previously thought arbitration agreements would not be enforced.

113. *See supra* Section I (illustrating judicial opinions in support of a pro-arbitration paradigm).

114. *See, e.g.*, Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1982) (noting that the FAA established a "federal policy favoring arbitration" and that the courts should "rigorously enforce agreements to arbitrate.").

115. Jean R. Sternlight, *Creeping Mandatory Arbitration: Is It Just?*, 57 STAN. L. REV. 1631, 1631–32 (2005) (citations omitted).

116. Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1982).

This Article contends that the FAA that Congress adopted over eighty years ago bears little resemblance to the Supreme Court's current interpretation of the FAA. The legislative history of the FAA indicates that the intention behind the law was to allow courts to enforce arbitration agreements between merchants.[117] Interestingly, members of Congress voiced concerns that the FAA would be used against unsuspecting investors. For example, Montana Senator Thomas Walsh, during a Joint Committee hearing, voiced his concern that:

> a great many of these contracts that are entered into are really not voluntary things at all . . . . A man says, 'These are our terms. All right, take it or leave it.' Well, there is nothing for the man to do except to sign it; and then he surrenders his right to have his case tried by the court, and has to have it tried before a tribunal in which he has no confidence at all."[118]

The Supreme Court seemed to overlook the legislative history that cautioned against enforcement of mandatory PDAAs on parties with unequal bargaining power.

The FAA's primary purpose was to ensure enforcement of arbitration agreements, not to encourage businesses to place mandatory PDAAs in their contracts with investors.[119] The legislative history and case law reflect that "arbitration is a matter of contract" and that the FAA puts arbitration agreements "on equal footing with other contracts"[120] and "creates no new legislation, grants no new rights, except a remedy to enforce an agreement in commercial contracts and in admiralty contracts."[121]

It is also important to note that though the Supreme Court speaks of a pro-arbitration policy in all of the cited cases,[122] the Court never states that Congress intended a pro-*mandatory* arbitration policy. Based upon the

117. *See Arbitration of Interstate Commercial Disputes: Hearing of S. 1005 and H.R. 646 Before the J. Comm. of Subcomms. on the Judiciary*, 68th Cong. 16 (1924) (statement of Julius Cohen, Gen. Counsel, N.Y. State Chamber of Commerce) (discussing the applicability of such agreements to federal court decisions that bind domestic and international trade agreements).

118. *Sales and Contracts to Sell in Interstate and Foreign Commerce, and Federal Commercial Arbitration: Hearing on S. 4213 and S. 4214 before a Subcomm. of the S. Comm. on the Judiciary*, 67th Cong., 4th Sess., 9 (1923) (statement of Sen. Thomas Walsh).

119. Dean Witter Reynolds Inc. v. Byrd, 470 U.S. 213, 219–20 (1985) (concluding that the FAA was designed "to overrule the judiciary's long-standing refusal to enforce agreements to arbitrate").

120. Janiga v. Questar Capital Corp., 615 F.3d 735, 740, 742 (7th Cir. 2010).

121. 65 CONG. REC. 1931 (1924) (statement of Rep. George S. Graham) (regarding the enforcement of arbitration agreements).

122. *See supra* Section I.A.

case law and the legislative history of the FAA, this is an important distinction. The Supreme Court has consistently held that arbitration is a matter of *consent*. In *Volt Information Sciences, Inc. v. Board of Trustees*, the Supreme Court held that under the FAA, arbitration "is a matter of consent, not coercion, and parties are generally free to structure their arbitration agreements as they see fit."[123] In *Stolt-Nielsen S.A. v. AnimalFeeds International Corp.*, the Supreme Court reaffirmed this idea by stating clearly that "[t]he Court ties the requirement of affirmative authorization to 'the basic precept that arbitration is a matter of consent, not coercion.'"[124] As noted in the next Section, brokerage and advisory contracts are offered on a "take it or leave it" basis and do not require the type of consent required by the Supreme Court.

B. Brokerage and Advisory Contracts are Contracts of Adhesion

A contract of adhesion is defined as a "standard-form contract prepared by one party, to be signed by another party in a weaker position . . . who adheres to the contract with little choice about the terms."[125] "An adhesion contract is typically a standardized form 'offered to consumers of goods and services on essentially a 'take it or leave it' basis without affording the consumer a realistic opportunity to bargain and under such conditions that the consumer cannot obtain the desired product or services except by acquiescing in the form contract.'"[126] Courts look at multiple factors to determine whether a contract is one of adhesion, including whether there was great disparity in bargaining power, no opportunity for negotiation, or services that could not be obtained elsewhere.[127]

Courts have found that brokerage and advisory contracts are generally contracts of adhesion.[128] "Adhesion contracts generally warrant heightened judicial scrutiny because the drafting party is in a superior bargaining

123. Volt Info. Scis., Inc. v. Bd. of Trs., 489 U.S. 468, 479 (1989).

124. Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp., 559 U.S. 662, 697–98 (2010) (quoting *Volt*, 489 U.S. at 479).

125. *Definition of Adhesion Contract*, BLACK'S LAW DICTIONARY (9th ed. 2009), *available at* Westlaw BLACKS.

126. Broemmer v. Abortion Servs. of Phx., Ltd., 840 P.2d 1013, 1015 (1992) (quoting Wheeler v. St. Joseph Hosp., 63 Cal. App. 3d 345, 356 (1976)); *see* Siegelman v. Cunard White Star Ltd., 221 F.2d 189, 204 (2d Cir. 1955) (noting that with one-sided control of a contract's terms "the usual contract rules, based on the idea of 'freedom of contract,' cannot be applied rationally").

127. Brenner v. Nat'l Outdoor Leadership Sch., 20 F. Supp. 3d 709, 717 (D. Minn. 2014).

128. *See, e.g.*, Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 230 (1987) ("arbitration clauses in securities sales agreements generally are not freely negotiated").

position,"[129] and although they will not be found unconscionable in every case, "an adhesion contract is procedurally unconscionable and unenforceable 'when the terms are patently unfair to the weaker party.'"[130] The Supreme Court, however, has stated that "[m]ere inequality in bargaining power . . . is not a sufficient reason to hold that arbitration agreements are never enforceable."[131] Enforceability also "depends upon whether the terms of the contract are beyond the reasonable expectations of an ordinary person . . . ."[132]

The preceding Sections reflect the contradictory nature of the Supreme Court's evolution on mandatory PDAAs. The Court has gone to great lengths to show that arbitration is a matter of consent, but then subsequently allows mandatory PDAAs in adhesion contracts where the investor may not even be aware of the clause binding them to future arbitration. Generally, an individual cannot consent to a contract provision that he or she is not aware of[133] or, in the alternative, to which he or she has not agreed.[134] The Supreme Court has also stated that "the FAA's pro-arbitration policy does not operate without regard to the wishes of the contracting parties,"[135] which reflects an implicit understanding that the FAA's presumption in favor of arbitration should only apply when both parties explicitly and voluntarily state their intention to enter into arbitration.

C. Mandatory Pre-Dispute Arbitration Agreements Are Per Se Unconscionable

Due to the pervasive use of adhesion contracts in the securities industry, investors are effectively forced to sign an agreement that binds

129. Rivera v. Am. Gen. Fin. Servs., Inc., 259 P.3d 803, 817 (N.M. 2011).

130. *Id.* (citation omitted).

131. Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20, 33 (1991).

132. Howell v. NHC Healthcare–Fort Sanders, Inc., 109 S.W.3d 731, 734 (Tenn. Ct. App. 2003).

133. O'Connor v. Combined Ins. Co. of Am., 441 Fed. App'x. 362, 366 (6th Cir. 2011) (quoting *In re Brown*, 287 B.R. 676, 682 (E.D. Mich. 2001)) ("It is axiomatic that a party cannot consent to terms of which it is unaware.").

134. The Third Circuit's general rule is that a party need not arbitrate unless it has agreed to such arbitration. Fencourt Reinsurance Co., Ltd. v. ITT Indus., Inc., 2008 WL 2502139, at *11 (E.D. Pa. 2008) (quoting Bel-Ray Co., Inc. v. Chemrite (Pty) Ltd., 181 F.3d 435, 444 (3d Cir. 1999) ("Arbitration is strictly a matter of contract. If a party has not agreed to arbitrate, the courts have no authority to mandate that he do so."); *cf.* Adam v. Merrill Lynch Pierce Fenner & Smith, 888 F.2d 696, 701 (10th Cir. 1989) (holding that a broker's failure to verbally disclose arbitration provisions did not render the provisions unenforceable because "the law presumes that one has read that which he has signed.").

135. Mastrobuono v. Shearson Lehman Hutton, Inc., 514 U.S. 52, 57 (1995).

them to all the terms contained therein, including mandatory PDAAs.[136] Mandatory PDAAs are not within investors' reasonable expectations and should be deemed *per se* unconscionable because they require investors' involuntary waiver of certain constitutional rights and provide narrow appellate avenues that effectively preclude judicial review of arbitral awards.

1. Involuntary Waiver of Constitutional Rights

This Article contends that by forcing unwitting investors into arbitration before a dispute arises, they are being forced to relinquish certain constitutional rights. As noted throughout this Article, arbitration is a perfectly legal and efficient method to resolve disputes; however, investors should not be deprived of that choice. Individuals may prospectively waive their constitutional rights to access the court system and due process of law; this principle is not at issue. The issue that arises with mandatory PDAAs is the manner in which those rights are relinquished by the investor.

The Seventh Amendment provides that "[i]n suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved . . . ."[137] This provision governs proceedings in federal court and not state court, but each state has a provision in its constitution that is analogous.[138] An individual may waive his or her constitutional right to a jury trial as long as that waiver is "knowing and voluntary." Under the knowing and voluntary standard, "for a waiver to be effective it must be clearly established that there was 'an intentional relinquishment or abandonment of a known right or privilege.'"[139] Courts will generally look to:

> (1) the conspicuousness of the [waiver] provision in the contract; (2) the level of sophistication and experience of the parties entering into the contract; (3) the opportunity to negotiate terms

136. N. AM. SEC. ADM'RS ASS'N ("NASAA"), MANDATORY BINDING ARBITRATION: IS IT FAIR AND VOLUNTARY? (2009), *available at* http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Arbitration-Statement-9.15.09.pdf ("Today, almost every broker-dealer includes in their customer agreements, a predispute arbitration provision that forces public investors to submit all disputes that they may have with the firm and/or its associated persons to mandatory arbitration.").

137. U.S. CONST. amend. VII.

138. *See, e.g.*, ALA. CONST. of 1901, art. I, § XI ("the right of trial by jury shall remain inviolate.").

139. Brookhart v. Janis, 384 U.S. 1, 4 (1966) (quoting Johnson v. Zerbst, 304 U.S. 458, 464 (1938)).

of the contract; (4) the relative bargaining power of each party; and (5) whether the waiving party was represented by counsel.[140]

The Supreme Court has traditionally been wary of waivers of constitutional rights in contracts of adhesion. In *Fuentes v. Shevin*, the Supreme Court found that there was "no showing whatever that the appellants were actually aware or made aware of the significance of the fine print now relied upon as a waiver of constitutional rights" and that "a waiver of constitutional rights in any context must, at the very *least*, be clear."[141] Similarly, in *Teamsters v. Terry*, the Supreme Court held that "'[m]aintenance of the jury as a fact-finding body is of such importance and occupies so firm a place in our history and jurisprudence that any seeming curtailment of the right to a jury trial should be scrutinized with the utmost care.'"[142]

Even with the Supreme Court's wariness on the issue of waivers of constitutional rights in contracts of adhesion, courts have held that an individual's waiver of his or her constitutional right to a jury trial under a mandatory PDAA does not have to meet the traditional "knowing and voluntary" standard for waiver. In *Caley v. Gulfstream*, the Eleventh Circuit held that "general contract principles govern the enforceability of arbitration agreements and that no heightened 'knowing and voluntary' standard applies, even where the covered claims include federal statutory claims generally involving a jury trial right."[143] Courts have also found that when a party enters into a valid agreement to arbitrate, the party is not entitled to a jury trial or to a judicial forum for covered disputes. In *Mitsubishi Motors Corp.*, the Supreme Court held that "[b]y agreeing to arbitrate a statutory claim, a party does not forego the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum."[144] Likewise in *American Heritage Life Ins. Co.*, the Fifth Circuit held that the Seventh Amendment does not "'confer the right to a trial, but only the right to have a jury hear the case once it is

140. Allyn v. W. United Life Assurance Co., 347 F. Supp. 2d 1246, 1252 (M.D. Fla. 2004) (citations omitted).

141. Fuentes v. Shevin, 407 U.S. 67, 95 (1972) (emphasis in original).

142. Chauffeurs, Teamsters & Helpers, Local No. 391 v. Terry, 494 U.S. 558, 565 (1990) (quoting Dimick v. Schiedt, 293 U.S. 474, 486 (1935)).

143. Caley v. Gulfstream Aerospace Corp., 428 F.3d 1359, 1372 (11th Cir. 2005) (citing Am. Heritage Life Ins. Co. v. Orr, 294 F.3d 702, 711 (5th Cir. 2002)) ("holding that parties' arbitration agreement, which stated that the right to a trial and to a jury were waived, validly waived those trial rights, and rejecting arguments that a heightened 'clear and unmistakable' or 'voluntary, knowing, and intelligent' standard applied to the waiver").

144. Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 628 (1985).

determined that the litigation should proceed before a court. If the claims are properly before an arbitral forum pursuant to an arbitration agreement, the jury trial right vanishes.'"[145]

Interestingly, even with the historical importance of jury trials, arbitrators have been placed in a higher regard and are given more discretion than jurors. The Supreme Court has been clear on this issue by stating that the trial judge in the federal system "'has . . . discretion to grant a new trial if the verdict appears . . . to be against the weight of the evidence.'"[146] However, concerning arbitration, the Supreme Court has stated that because arbitrators do not have the benefit of judicial instruction on the law, "they need not give their reasons for their results; the record of their proceedings is not as complete as it is in a court trial; and judicial review of an award is more limited than judicial review of a trial."[147]

The language in the preceding sentence is startling—an unreasoned decision made by individuals with neither instruction on nor mandate to follow any applicable law is given less judicial review than a decision made by a group of individuals who are given instruction on the law and are mandated to follow and apply that law to the facts of a case.

Mandatory PDAAs also force investors to give up their constitutional right to due process of law. In *Davis v. Prudential*, a customer arbitration case, the Eleventh Circuit held that "the state action element of a due process claim is absent in private arbitration cases."[148] The Seventh Circuit similarly held in *Elmore v. Chicago & Illinois Midland Railway Co.* that "the fact that a private arbitrator denies the procedural safeguards that are encompassed by the term 'due process of law' cannot give rise to a constitutional complaint."[149] It is important to note, that FINRA is a private entity. For the purposes of National Association of Securities Dealers (NASD) (now FINRA) arbitrations, courts have found that actions in the arbitration process are not state action because they arise from a private agreement.[150] FINRA may engage in quasi-judicial functions, but that does not mean it is a state actor.[151]

145. *Am. Heritage Life Ins. Co.*, 294 F.3d at 711 (quoting Cremin v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 957 F. Supp. 1460, 1471 (N.D. Ill. 1997)).

146. Gasperini v. Ctr. for Humanities, Inc., 518 U.S. 415, 433 (1996) (quoting Byrd v. Blue Ridge Rural Elec. Coop., Inc., 356 U.S. 525, 537 (1958)).

147. Bernhardt v. Polygraphic Co. of Am., 350 U.S. 198, 203 (1956).

148. Davis v. Prudential Securities, Inc. 59 F.3d 1186, 1191–92 (11th Cir. 1995); *see* Austern v. Chi. Bd. Options Exch., Inc., 716 F. Supp. 121, 125 (S.D.N.Y. 1989) (ruling that conduct of exchange arbitration panel was not state action), *aff'd*, 898 F.2d 882 (2d Cir. 1990).

149. Elmore v. Chi. & Ill. Midland Ry. Co., 782 F.2d 94, 96 (7th Cir. 1986).

150. *See* Bahr v. Nat'l Ass'n of Sec. Dealers, 763 F. Supp. 584, 589 (S.D. Fla. 1991) (concluding that the conduct at issue was only of a private corporation, not a state actor).

151. *See* Board of Governors Decision, *supra* note 79, at 17 n.18 (citing Desiderio v.

It is instructive to look at an example of a mandatory PDAA in a brokerage contract under the construct above. For this Article, the mandatory PDAA at issue in the *FINRA v. Schwab* enforcement action will be used.[152] First, the mandatory PDAA is not in the actual contract; it is provided as an additional disclosure document that does not need to be signed by the investor. The only mention of the mandatory PDAA is on Page 6 (out of 6) of the brokerage contract which states that "[b]y signing this Application, you acknowledge that you have received and read a copy of the attached Application Agreement, which contains a predispute arbitration provision" and "[t]he Agreement with Schwab includes a predispute arbitration clause. You acknowledge receipt of the predispute arbitration clause . . . ."[153] This language is interesting because it only speaks of a pre-dispute arbitration clause, but nothing about the *mandatory* nature of such clause.

Based upon the discussion above, investors can be forced to relinquish rights granted to them under the U.S. Constitution and forced to enter a dispute resolution system that is less transparent, with no guarantee of due process of law, and, as discussed below, it is infinitely more difficult to get judicial review of an erroneous decision.

2. Narrow Appellate Avenues Effectively Preclude Judicial Review of Arbitral Awards

For the past two decades, arbitration in forums sponsored by the securities industry has been the primary mechanism for the resolution of disputes among investors, brokerage firms, and brokers. FINRA currently operates as the largest dispute resolution forum in the securities industry and has created rules by which its arbitrators must operate.[154] It is

Nat'l Ass'n of Secs. Dealders, 191 F.3d 198, 206–07 (2d Cir. 1999) (affirming trial court's dismissal of plaintiff's constitutional claims challenging the arbitration clause in the Form U4 because NASD is not a state actor nor can its actions be fairly attributable to the state)); *see also Austern*, 716 F. Supp. at 125 (holding that the conduct of an arbitration panel "did not in any way constitute state action"); FDIC v. Air Fla. Sys., Inc., 822 F.2d 833, 842 n.9 (9th Cir. 1987) ("The arbitration involved here was private, not state, action; it was conducted pursuant to contract by a private arbitrator. Although Congress, in the exercise of its commerce power, has provided for some governmental regulation of private arbitration agreements, we do not find in private arbitration proceedings the state action requisite for a constitutional due process claim.").

152. *Accounts*, CHARLES SCHWAB, http://www.schwab.com/public/schwab/investing/accounts_products/accounts (last visited Mar. 26, 2015) (providing a link to the Brokerage Account Application Agreement).

153. *Id.* at 6.

154. *See* FINRA RULE 12000, FINRA MANUAL: CODE OF ARBITRATION PROCEDURE FOR CUSTOMER DISPUTES, FIN. INDUS. REGULATORY AUTH. (as amended in 2008), *available at*

important to note that this forum is separate from FINRA's disciplinary function discussed earlier in the Article. These rules cover filing and responding to a claim, hearings and discovery, and appointment and authority of the arbitrator(s).[155] FINRA's rules do not provide a process through which a party may challenge an arbitration award. Thus, to challenge an award a party must file an action in federal court to vacate the decision under the very limited circumstances prescribed in the FAA:

> (1) where the award was procured by corruption, fraud, or undue means; (2) where there was evident partiality or corruption in the arbitrators, or either of them; (3) where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced; or (4) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.[156]

Parties who seek to challenge a final arbitration award have very few options. As noted above, there are limited avenues to vacate a valid arbitration award. To determine the scope of these options, it is useful to analyze the case law. Because the appellate rights originate under the FAA and not FINRA rules, the cases discussed below include non-securities arbitrations.

a. Burden of Proof Upon Aggrieved Party and Courts Extremely Deferential to Arbitrators

As a starting point, a court's limited ability to review an arbitration award has been described as "'among the narrowest known to the law.'"[157] There is a presumption that arbitration awards will be confirmed.[158]

---

http://finra.complinet.com/en/display/display_main.html? rbid=2403&element_id=4096 (detailing the rules by which the FINRA arbitrators are bound).

155. *Id.*

156. 9 U.S.C. § 10 (2012 & Supp. I 2013).

157. *See, e.g.*, Denver & Rio Grande W. R.R. v. Union Pac. R.R., 119 F.3d 847, 849 (10th Cir. 1997) (quoting ARW Exploration Corp. v. Aguirre, 45 F.3d 1455, 1462 (10th Cir. 1995) (holding a court could not review an arbitration award despite having jurisdiction over the matter).

158. *See* Frazier v. CitiFinancial Corp., LLC, 604 F.3d 1313, 1324 (11th Cir. 2010) (holding that a court has no basis to overturn an arbitrator's decision outside of statutory grounds).

The party moving to vacate bears the burden of refuting every rational basis on which the arbitrator could have relied.[159] In *Collins v. Chicago Investment Group, LLC*, the plaintiff was appealing an adverse determination by a FINRA arbitration panel.[160] The U.S. District Court for the District of Nevada found that "[t]he burden of establishing grounds for vacating an arbitration award is on the party seeking vacatur"[161] and that "[r]eview of the award is 'both limited and highly deferential.'"[162] In *Goldman Sachs Execution & Clearing, L.P. v. Official Unsecured Creditors' Committee of Bayou Group, LLC*, the Second Circuit reinforced that the review of an arbitration award "is 'highly deferential' to the arbitrators, and relief on such a claim is therefore 'rare.'"[163]

The Second Circuit held in *Wallace v. Buttar* that the party moving to vacate an arbitration award bears the "heavy burden of showing that the award falls within a very narrow set of circumstances delineated by statute and case law."[164] In *Banco de Seguros del Estado v. Mutual Marine Office, Inc.*, the same court stated it has:

> 'consistently accorded the narrowest of readings' to the FAA's authorization to vacate awards . . . [and the Court's] inquiry 'focuses on whether the arbitrators had the power based on the parties' submissions or the arbitration agreement, to reach a certain issue, not whether the arbitrators correctly decided that issue.[165]

159. First Pres. Capital, Inc. v. Smith Barney, Harris Upham & Co., Inc., 939 F. Supp. 1559, 1564 (S.D. Fla. 1996).

160. Collins v. Chi. Inv. Group, LLC, 2012 U.S. Dist. LEXIS 37217 (D. Nev. 2012).

161. *Id.* at *1 (citing U.S. Life Ins. Co. v. Superior Nat'l Ins. Co., 591 F.3d 1167, 1173 (9th Cir. 2010)).

162. *Id.* at *2 (quoting Poweragent Inc. v. Elec. Data. Sys. Corp., 358 F.3d 1187, 1193 (9th Cir. 2004)).

163. Goldman Sachs Execution & Clearing, L.P. v. Official Unsecured Creditors' Comm. of Bayou Grp., LLC, 491 Fed. App'x. 201, 203 (2d Cir. 2012) (quoting STMicroelectronics, N.V. v. Credit Suisse Securities (USA) LLC, 648 F.3d 68, 78 (2d Cir. 2011)).

164. Wallace v. Buttar, 378 F.3d 182, 189 (2d Cir. 2004) (quoting Duferco Int'l Steel Trading v. T. Klaveness Shipping A/S, 333 F.3d 383, 388 (2d Cir. 2003)).

165. Banco de Seguros del Estado v. Mut. Marine Office, Inc., 344 F.3d 255, 262 (2d Cir. 2003) (quoting Westerbeke Corp. v. Daihatsu Motor Co., 304 F.3d 200, 220 (2d Cir. 2002)); *see* Stolt-Nielson S.A. v. AnimalFeeds Int'l Corp., 559 U.S. 662, 67 (2010) (stating that a party seeking vacatur of an arbitrator's decision "must clear a high hurdle").

The Court's review is to "determine only whether the arbitrator did his job—not whether he did it well, correctly, or reasonably, but simply whether he did it."[166]

The courts' opinions concerning deference to arbitrators are in direct conflict with the opinions concerning deference to a governmental agency. For example, as noted above, courts are not obligated to defer to an agency's interpretation of Supreme Court precedent.[167] By contrast, arbitrators do not have to follow Supreme Court precedent, but, in the event they do, a court's review of an arbitration award is 'highly deferential' to the arbitrators. This contradiction reflects a decision to arbitrarily grant deference to a group of individuals who generally have less legal training and would ultimately be more likely to misinterpret Supreme Court jurisprudence.

b. Lack of Rationale Does Not Invalidate Award

FINRA rules do not require an arbitrator to provide a reasoned opinion for his or her decision.[168] In *Goldman Sachs*, the Court held that "an arbitral award must 'be enforced, despite a court's disagreement with it on the merits, if there is a *barely colorable justification* for the outcome reached.'"[169] Similarly, in *STMicroelectronics*, the Court held that even where an arbitration panel does "not explain the reason for [its] decision, we will uphold it if we can discern any valid ground for it."[170]

The Ninth Circuit held in *Kyocera Corp. v. Prudential-Bache Trade Services, Inc.* that "[n]either erroneous legal conclusions nor unsubstantiated factual findings justify federal court review of an arbitral award under the [FAA], which is unambiguous in that regard."[171] Then, in *D.H. Blair & Co., Inc. v. Gottdiener*, the Second Circuit held that the "arbitrator's rationale for an award need not be explained, and the award should be confirmed 'if a ground for the arbitrator's decision can be inferred from the facts of the case.' Only 'a barely colorable justification

166. Mountaineer Gas Co. v. Oil, Chem. & Atomic Workers Int'l Union, 76 F.3d 606, 608 (4th Cir. 1996).

167. N.Y. N.Y., LLC v. N.L.R.B., 313 F.3d 585, 590 (D.C. Cir. 2002).

168. *Decisions and Awards*, FIN. INDUS. REGULATORY AUTH., *available at* http://www.finra.org/arbitrationandmediation/arbitration/process/decisionawards/ (last visited Mar. 5, 2015).

169. *Goldman*, 491 Fed. App'x. at 204 (emphasis in original) (quoting *Wallace*, 378 F.3d at 190).

170. STMicroelectronics, N.V. v. Credit Suisse Secs. (USA) LLC, 648 F.3d 68, 78 (2d Cir. 2011).

171. Kyocera Corp. v. Prudential-Bache Trade Servs., Inc., 341 F.3d 987, 994 (9th Cir. 2003).

for the outcome reached' by the arbitrators is necessary to confirm the award."[172]

Using an example from the securities industry, in *Raiford v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, the Eleventh Circuit held that an arbitration award for brokerage churning damages was not shown to be arbitrary and capricious where the arbitrator gave no explanation at all for his decision.[173] Even though in this case the decision favored the investor, the next case could just as easily favor the broker.

c. Impartiality, Bias of Arbitrators, and Presentation of Evidence

Under 9 U.S.C. § 10(a)(2), a party may vacate an arbitration award where there was evident partiality or corruption of the arbitrators. Courts have routinely held that this is a high burden to meet. For example, in *Scandinavian Reinsurance Co. Ltd. v. St. Paul Fire & Marine Insurance Co.*, the Second Circuit held that even where an arbitrator fails to abide by arbitral or ethical rules concerning disclosure of possible conflicts, such failure does not, in itself, entitle the losing party to vacatur of the arbitration award.[174] Indeed, the Sixth Circuit has noted that "[t]he alleged partiality must be direct, definite, and capable of demonstration."[175]

Plaintiffs also have a very high burden for proving bias on the part of the arbitrators. For example, in *Kolel Beth Yechiel Mechil of Tartikov, Inc. v. YLL Irrevocable Trust*, an overheard conversation in which an arbitrator allegedly said that one party would receive a favorable decision was not direct or definite evidence of bias.[176]

Courts have also held that arbitrators can proceed with a decision without necessarily having to procure all relevant evidence. In *United Paperworkers International Union, AFL-CIO v. Misco, Inc.*, the Supreme Court concluded that even assuming "that the arbitrator erred in refusing to consider the disputed evidence, his error was not in bad faith or so gross as

172. D.H. Blair & Co., Inc. v. Gottdiener, 462 F.3d 95, 110 (2d Cir. 2006) (quoting Barbier v. Shearson Lehman Hutton, Inc., 948 F.2d 117, 121 (2d Cir. 1991); Landy Michaels Realty Corp. v. Local 32B–32J, Serv. Emps. Int'l Union, 954 F.2d 794, 797 (2d Cir. 1992)).

173. Raiford v Merrill Lynch, Pierce, Fenner & Smith, Inc., 903 F.2d 1410 (11th Cir. 1990).

174. Scandinavian Reinsurance Co. Ltd. v. St. Paul Fire & Marine Ins. Co., 668 F.3d 60, 74 (2d Cir. 2012).

175. Nationwide Mut. Ins. Co. v. Home Ins. Co., 278 F.3d 621, 626 (6th Cir. 2002) (quoting Andersons, Inc. v. Horton Farms, Inc., 166 F.3d 308, 329 (6th Cir. 1998)).

176. Kolel Beth Yechiel Mechil of Tartikov, Inc. v. YLL Irrevocable Trust, 729 F.3d 99, 106 (2d Cir. 2013).

to amount to affirmative misconduct."[177] Additionally, in *National Casualty Co. v. First State Insurance Group*, the First Circuit held that there was no misconduct when the arbitration panel issued the award without forcing the defendant company to produce relevant documents, because the arbitration panel acted within its authority when it chose to render a decision after drawing inferences against the company as to what documents would show.[178] In short, the arbitrators were allowed to divine what the documents would show without the necessity of reviewing them.

d. "Manifest Disregard of the Law"

Barring outright fraud, deceit, or impartiality of the arbitrators, claims to vacate an arbitration award must be brought under 9 U.S.C. § 10(a)(4), which states that an award may be vacated "where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made."[179] As noted above, the aggrieved party has a high burden to show that the arbitrator exceeded his or her power. In order to overturn an arbitral decision for excess use of power on the part of the arbitrators, the terms of the award must be "completely irrational."[180] To be "completely irrational," the arbitrators' decision must "'escape[] the bounds of rationality'" and be entirely unsupported by the record.[181]

Multiple circuits have also found two additional grounds upon which an award may be vacated: namely, where the arbitrator's award is in "manifest disregard" of the law[182] or the terms of the relevant agreement between the parties are outside the reasonable expectations of the weaker party.[183] Courts have found that "'[m]anifest disregard of the law' means

177. United Paperworkers Int'l Union, AFL-CIO v. Misco, Inc., 484 U.S. 29, 40 (1987).

178. Nat'l Cas. Co. v. First State Ins. Group, 430 F.3d 492, 497 (1st Cir. 2005).

179. 9 U.S.C. § 10(a)(4) (2012 & Supp. I 2013).

180. Sherrock Bros., Inc. v. DaimlerChrysler Motors Co., 260 F. App'x 497, 501 (3d Cir. 2008).

181. Franko v. Ameriprise Fin. Servs., 2009 U.S. Dist. LEXIS 48907, at *10 (E.D. Pa. 2009) (quoting Southco, Inc. v. Reell Precision Mfg. Corp., 556 F. Supp. 2d 505, 511 (E.D. Pa. 2008)).

182. This Article contends that the Supreme Court's decision in *Hall Street Assocs., L.L.C. v. Mattel, Inc.* does not preclude "manifest disregard" of the law as a ground to vacate an arbitration award. Comedy Club, Inc. v. Improv W. Assoc., 553 F.3d 1277, 1290 (9th Cir. 2009), *cert. denied*, Improv W. Assoc. v. Comedy Club, Inc., 558 U.S. 824 (2009) (concluding that "after *Hall Street Associates*, manifest disregard of the law remains a valid ground for vacatur" because it is "shorthand for a statutory ground under the FAA, specifically 9 U.S.C. § 10(a)(4)").

183. *See, e.g.*, Schwartz v. Merrill Lynch & Co., Inc., 665 F.3d 444, 451–52 (2d Cir. 2011) (holding that a court may set aside an arbitration award if it was rendered in manifest

something more than just an error in the law or a failure on the part of the arbitrators to understand or apply the law."[184] In *Misco*, the Supreme Court held that "as long as the arbitrator is even arguably construing or applying the contract and acting within the scope of his authority, that a court is convinced he committed serious error does not suffice to overturn his decision."[185] It is not enough to say that the arbitrator erred in resolving conflicting precedent in favor of the defendant.[186] "It must be clear from the record that the arbitrators recognized the applicable law and then ignored it."[187] For a plaintiff to succeed, he or she is required to show that "the arbitrators were aware of the law, understood it correctly, found it applicable to the case before them, and yet chose to ignore it in propounding their decision."[188]

To provide an example of how narrowly courts view the "manifest disregard" of the law, in *Montes v. Shearson Lehman Brothers, Inc.*, the prevailing party of the arbitration contended that the arbitrator could ignore the law if doing so would provide a fair result.[189] The Eleventh Circuit vacated the award because:

> the party who obtained the favorable award had conceded to the arbitration panel that its position was not supported by the law, which required a different result, and had urged the panel not to follow the law . . . [and] that blatant appeal to disregard the law was explicitly noted in the arbitration panel's award.[190]

It is important to note that the *Montes* case "remains the sole instance in which the 11th Circuit has 'ever found the exceptional circumstances that

disregard of the law).

184. *See, e.g.*, Fin. Network Inv. Corp. v. Karoon, 540 Fed. App'x. 597 (9th Cir. 2013) (providing a working definition of manifest disregard of the law).

185. United Paperworkers Int'l Union, AFL-CIO v. Misco, Inc., 484 U.S. 29, 38 (1987).

186. Goldman v. Architectural Iron Co., 306 F.3d 1214, 1217 (2d Cir. 2002).

187. Mich. Mut. Ins. Co. v. Unigard Sec. Ins. Co., 44 F.3d 826, 832 (9th Cir. 1995); *see* O.R. Sec., Inc. v. Prof'l Planning Assocs., 857 F.2d 742, 747 (11th Cir. 1988) (stating that the knowing disregard of the law must be apparent on the face of the record.); *see also* Carter v. Health Net of Cal., Inc., 374 F.3d 830, 838 (9th Cir. 2004) (quoting *Mich. Mut. Ins.*, 44 F.3d at 832) (noting that "[a]s federal courts of appeals have repeatedly held, '"manifest disregard of the law" means something more than just an error in the law or a failure on the part of the arbitrators to understand or apply the law. It must be clear from the record that the arbitrators recognized the applicable law and then ignored it.'").

188. Remmey v. PaineWebber, Inc., 32 F.3d 143, 149 (4th Cir. 1994).

189. Montes v. Shearson Lehman Bros., Inc., 128 F.3d 1456, 1461–62 (11th Cir. 1997).

190. *Id.* at 1464 (Carnes, J., concurring).

satisfy the exacting requirements' justifying the vacation of an award due to manifest disregard for the law."[191]

Courts will not disturb factual findings by the arbitrator, if any are even made, and have consistently held that arbitration awards should not be vacated even if the arbitrators erred by making "contradictory findings of fact."[192] For example, in *Oxford Health Plans, LLC v. Sutter*, the Supreme Court held that "convincing a court of an arbitrator's error—even his grave error—is not enough. So long as the arbitrator was 'arguably construing' the contract—which this one was—a court may not correct his mistakes under [the FAA]."[193] Thus, the court noted that "'[w]hether or not the panel's findings are supported by the evidence in the record is beyond the scope of [the Court's] review.'"[194] The lack of rationale required under the FAA affects the Court's ability to review an arbitration award—"[w]hen arbitrators do not state their reasons for an award, 'it is nearly impossible for the court to determine whether they acted in disregard of the law.'"[195]

Further confirming the oppressively narrow view taken by courts when reviewing arbitration awards, in *Reliastar Life Insurance Co. v. EMC National Life Co.*, the Second Circuit held that "'as long as the arbitrator is even arguably construing or applying the contract and acting within the scope of his authority,' a court's conviction that the arbitrator has 'committed serious error' in resolving the disputed issue 'does not suffice to overturn his decision.'"[196] Indeed, courts will not vacate an award under

191. Rueter v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 440 F. Supp. 2d 1256, 1262 (D. Ala. 2006) (quoting *Montes*, 128 F.3d at 1461.)

192. *See, e.g.*, Bosack v. Soward, 586 F.3d 1096, 1106 (9th Cir. 2009).

193. Oxford Health Plans LLC v. Sutter, 133 S.Ct. 2064, 2070 (2013).

194. Lagstein v. Certain Underwriters at Lloyd's, London, 607 F.3d 634, 642 (9th Cir. 2010) (quoting *Bosack*, 586 F.3d at 1106); *see* Kennecott Utah Copper Corp. v. Becker, 195 F.3d 1201, 1204 (10th Cir. 1999) (clarifying the manifest disregard standard by noting it applies only to conclusions of law, not to the arbitrator's factual findings, which are beyond review).

195. Aetna Cas. & Sur. Co. v. Dravo Corp., No. 97-149, 1997 U.S. Dist. LEXIS 11648, at *4 (E.D. Pa. Aug. 1, 1997) (quoting O.R. Sec., Inc. v. Prof'l Planning Assoc., Inc., 857 F.2d 742, 747 (11th Cir. 1988)).

196. Reliastar Life Ins. Co. v. EMC Nat'l Life Co., 564 F.3d 81, 86 (2d Cir. 2009) (quoting United Paperworkers Int'l Union AFL-CIO v. Misco, Inc., 484 U.S. 29, 38 (1987)). Where parent contended that stock in family corporation was placed in children's names for purposes of estate planning and tax avoidance, and that arbitrator improperly found that children owned majority of stock because they gave consideration for stock, arbitrator's failure to specifically discuss any legal reasoning does not establish that arbitrator identified applicable law and disregarded it, as required to vacate award based on manifest disregard of law. Van Horn v. Van Horn, 393 F. Supp. 2d 730 (N.D. Iowa 2005); *see* Hutchinson v. Farm Family Cas. Ins. Co., 500 F. Supp. 2d 87 (D. Conn. 2007) (holding that arbitration award may not be vacated on the grounds that the arbitrator failed to interpret correctly law applicable to issues in dispute or misinterpreted underlying contract).

this standard "because of 'a simple error in law or a failure by the arbitrators to understand or apply it' but only when a party clearly demonstrates 'that the panel intentionally defied the law.'"[197] Courts have also found that they will not "vacate an arbitral award merely because [they are] convinced that the arbitration panel made the wrong call on the law."[198] Arbitrators "cannot be said to disregard a law that is unclear or not clearly applicable. Thus, misapplication of an ambiguous law does not constitute manifest disregard."[199] Arbitrariness and capriciousness is also not an independent non-statutory ground for vacatur under the FAA.[200]

It is important to note that even though arbitrators have virtually unlimited discretion regarding the facts and the law in a specific case, they must still generally abide by FINRA's procedural rules of arbitration.[201] In practice, however, because of the lack of reasoning required in the arbitration award and the courts' hesitance to scrutinize arbitrations post-award, it is likely that there will be very few successful challenges using this argument.

e. *Analysis*

Based upon the case law discussed above, it appears that an investor or financial service provider seeking to vacate an arbitration award has virtually no chance of being successful in the absence of outright fraud or an instance where the arbitrator intentionally disregards the law and then publishes a written decision attesting to those facts.[202] It is telling that even adamant supporters of arbitration agree that there is virtually no effective way to appeal an erroneous arbitral award. Catholic University law professor Peter B. Rutledge, who has authored numerous studies on the benefits of arbitration,[203] has stated that "the grounds for vacatur are

197. StMicroelectronics, N.V. v. Credit Suisse Sec. (USA) LLC, 648 F.3d 68, 78 (2d Cir. 2011) (quoting Dufuerco Int'l Steel Trading v. T. Klaveness Shipping A/S, 333 F.3d 383, 389, 393 (2d Cir. 2003)).

198. Wallace v. Buttar, 378 F.3d 182, 190 (2d Cir. 2004).

199. *Duferco*, 333 F.3d at 383.

200. Brabham v. A.G. Edwards & Sons, Inc., 376 F.3d 377 (5th Cir. 2004).

201. *See* Kashner Davidson Sec. Corp. v. Mscisz, 531 F.3d 68 (1st Cir. 2008) (holding an arbitrator's failure to abide by procedural rules when arriving at the arbitral award may support a manifest disregard of the law challenge.), *cf.* Delta Mine Holding Co. v AFC Coal Props., 280 F.3d 815 (8th Cir. 2001) (determining that only the grounds listed under 9 U.S.C. § 10 justify vacating an award and arbitration rules and ethical codes do not have force of law).

202. *See supra* Section II.C.2.

203. *See, e.g.*, PETER B. RUTLEDGE, CHAMBER OF COMMERCE INST. FOR LEGAL REFORM, ARBITRATION—A GOOD DEAL FOR CONSUMERS: A RESPONSE TO PUBLIC CITIZEN (2008), *available at* http://www.adrforum.com/rcontrol/documents/ResearchStudiesAndStatistics/

themselves extremely narrow, and the opportunity for judicial review of the award's substance virtually non-existent."[204]

To show how absurd these requirements are in practice, courts have found that "[n]either erroneous legal conclusions nor unsubstantiated factual findings justify federal court review"[205] and there is no requirement for an arbitrator to provide a reasoned opinion for his or her decision. Based upon the legal precedent, an arbitrator may provide an incorrect legal conclusion, which is not substantiated by any factual finding, and the investor will still not be able to vacate the award.[206]

For example, assume that the investor wanted to vacate the arbitration award based upon the fact that the arbitrator found that his or her broker was not a fiduciary. Because the existence of a fiduciary duty is fact specific, the Court would not be able to review that determination. Even if the court did have the power to review the factual determination, the arbitrator has no legal duty to provide one. Even if the court believed that the arbitrator incorrectly interpreted the law by finding that the broker was not a fiduciary, unless the investor was able to show that the arbitrator knew the law and specifically ignored it, the court would not be able to vacate the arbitration.[207]

Investors may even be sanctioned for attempting to vacate the arbitration award. In *Rueter v. Merrill Lynch, Pierce, Fenner & Smith*, the District Court for the Northern District of Alabama denied the investor's motion to vacate and for reconsideration but granted the broker-dealer's motion for sanctions.[208] The Court held that a sanctions award was proper because the investor's legal theory had no reasonable chance of success and could not be advanced as a reasonable argument to change existing law.[209] Going further, even if an investor is able to vacate an adverse arbitration award, the investor "must then return to arbitration to relitigate the matter

200804ArbitrationGoodForConsumers-Rutledge.pdf (providing a detailed analysis of the benefits of arbitration).

204. Peter B. Rutledge, *Market Solutions to Market Problems: Re-Examining Arbitral Immunity as a Solution to Unfairness in Securities Arbitration*, 26 PACE L. REV. 113, 125 (2005).

205. Kyocera Corp. v. Prudential-Bache Trade Servs., Inc., 341 F.3d 987, 994 (9th Cir. 2003).

206. *See., e.g.*, Oxford Health Plans LLC v. Sutter, 133 S.Ct. 2064, 2070 (2013); Bosack v. Soward, 586 F.3d 1096, 1106 (9th Cir. 2009)

207. Wachovia Sec., LLC v. Brand, 671 F.3d 472, 483 (4th Cir. 2012) (determining that in order to vacate an arbitration award due to manifest disregard of the relevant law, the movant must show that: "'(1) the applicable legal principle is clearly defined and not subject to reasonable debate; and (2) the arbitrator[ ] refused to heed that legal principle.'")).

208. Rueter v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 440 F. Supp. 2d 1256 (N.D. Ala. 2006).

209. *Id.*

at substantial expense, on top of the already substantial expense of bringing the vacatur action in court."[210]

This author is aware of the arguments that the finality of an arbitration award benefits the investor, focusing on the costs to an investor if the firm appeals the trial court's decision, and the speed of arbitration panels versus the court system.[211] Based upon the current legal structure governing arbitrations, however, an arbitration proceeding may ultimately end up costing the investor more than they would have paid at the court. This is because, as noted above, the investor must go to court to enforce a positive arbitration award or litigate an adverse arbitration award.[212] Investors may also be sanctioned for appealing their awards.[213] The lack of appellate rights for either party in an arbitration is an absolute based upon rules and decisions that have been mandated by lower courts and confirmed by the Supreme Court.[214] So the real issue is whether the investor has a generally faster and cheaper dispute resolution or whether the investor has the ability to appeal an adverse arbitration award.

This argument is irrelevant, however, to the issue of mandatory PDAAS. It is important to note that while an arbitration *may* be less costly and more efficient, the aggrieved party will *definitely* not receive effective judicial review. In *Oxford Health Plans, LLC*, the Supreme Court stated that "the potential for . . . mistakes is the price of *agreeing* to arbitration."[215] However, this is the exact choice that mandatory PDAAs take away from investors.

3. Unconscionability Analysis

This Article contends that mandatory PDAAs are *per se* unconscionable because they require investors to involuntarily waive certain constitutional rights and provide narrow appellate avenues that effectively preclude judicial review of arbitral awards. An agreement to arbitrate is valid, irrevocable, and enforceable, as a matter of federal law "save upon such grounds as exist at law or in equity for the revocation of

210. Peter B. Rutledge, *Toward a Contractual Approach for Arbitral Immunity*, 39 GA. L. REV. 151, 194 (2004).

211. *See e.g.*, *The Securities Arbitration System: Hearing Before the Subcomm. on Capital Mkts., Ins. & Gov't Sponsored Enters. of the H. Comm. On Fin. Servs.*, 109th Cong. 15-17 (2005) (statement of Marc E. Lackritz, President, Sec. Indus. Ass'n).

212. Rutledge, *supra* note 210, at 194.

213. *See* Reuter, 440 F. Supp. 2d 1256.

214. *See, e.g.*, Wilko v. Swan, 346 U.S. 427, 436 (1953) (courts' "power to vacate an award is limited").

215. Oxford Health Plans LLC v. Sutter, 133 S. Ct. 2064, 2070 (2013) (emphasis added).

any contract."[216] It is informative to look at how courts have interpreted the unconscionability doctrine and how it applies to the arguments made herein.

The Supreme Court in *Concepcion* held that "[a] finding of unconscionability requires 'a "procedural" and a "substantive" element, the former focusing on "oppression" or "surprise" due to unequal bargaining power, the latter on "overly harsh" or "one-sided" results.'"[217] Most courts have focused on the unconscionability of the terms of the arbitration agreement rather than, as this Article contends, the legal regime governing arbitration. This Article contends that mandatory PDAAs in the securities industry are *per se* unconscionable based upon the involuntary waiver of certain constitutional rights, lack of due process of law, and lack of judicial review.[218]

Mandatory PDAAs meet the first prong of the unconscionability test (procedural), because an investor would be surprised to learn that by agreeing to work with a financial advisor, he or she is required to relinquish his or her constitutional rights to access the courts and to due process of law.[219] As noted above in the Schwab brokerage agreement, the actual contract makes no mention of the mandatory nature of the arbitration; it is only when the investor reads the arbitration clause buried in the disclosure document that the investor realizes that he or she is subject to mandatory arbitration.[220] Investors would also be surprised to learn that arbitrators do not have to follow the law in the arbitration proceeding, provide a reasoned decision, or gather all relevant evidence.[221] Investors are subject to oppression, because they generally do not realize they have involuntarily relinquished these rights until a dispute arises, which could be months or years after signing the initial contract.[222]

Mandatory PDAAs also meet the second prong of the unconscionability test (substantive), because under the current legal regime, these agreements provide narrow appellate avenues that effectively preclude judicial review. As discussed above, the opportunity for judicial

216. Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983).

217. AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740, 1746 (2011) (quoting Armendariz v. Found. Health Psychcare Servs., 6 P.3d 669, 690 (Cal. 2000)).

218. *See supra* Section II.C.1.

219. *Id.*

220. *See* Schwab, *supra* note 152 (exemplifying mandatory PDAA common in brokerage contracts).

221. *See supra* Section II.C.2.

222. *See* Jeff Sovern, et al., *'Whimsy Little Contracts' with Unexpected Consequences: An Empirical Analysis of Consumer Understanding of Arbitration Agreements* (St. John's Legal Studies Research Paper No. 14-0009, 2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2516432.

review of an arbitration award's substance is virtually non-existent.[223] This Article contends that the legal regime governing the appeal of arbitration awards leads to extremely "one-sided" results; however, it is one-sided with regard to the prevailing party in the arbitration rather than the drafter of the agreement. For example, regardless of whether the investor or financial service provider prevail in the arbitration, the losing party effectively has no recourse to judicial review.[224]

In *Highway Equipment Co. v. Caterpillar, Inc.*, the Sixth Circuit held that "[t]o be unconscionable, a contract must be one 'which no man in his senses, not under delusion, would make, on the one hand, and which no fair and honest man could accept, on the other.'"[225] Based upon the Section below that discusses how a mandatory PDAA would read under the current legal regime,[226] no investor or financial service provider would be likely to sign such an agreement.

This Article also contends that this analysis does not run afoul of the holding in *Concepcion* that found that generally applicable contract defenses, such as duress or unconscionability, were alleged to have been applied in a fashion that disfavors arbitration.[227] As noted above, arbitration is appropriate for a number of investors; however, investors should be able to make the choice based upon their own circumstances.

The unconscionability doctrine, as applied in this Article, only disfavors mandatory arbitration; it has no effect on voluntary arbitration. This is a distinction that has been repeatedly stated throughout this Article and has been explicitly affirmed by the courts—arbitration is a matter of *consent*.[228] Once an investor is informed of his or her rights under an arbitration agreement and chooses to arbitrate his or her claim, the investor is subject to those terms. However, because of the constitutional rights involved and the lack of access to judicial review, the Supreme Court should clearly separate mandatory and voluntary arbitration. The court should use the substance of this Article to illustrate that while voluntary arbitration can be a less costly and efficient method for dispute resolution, forcing investors into that system will never be acceptable.

223. *See supra* Section II.C.2.
224. *See supra* Section II.C.2.e.
225. Highway Equip. Co. v. Caterpillar, Inc., 908 F.2d 60, 65 (6th Cir. 1990) (quoting Hume v. United States, 131 U.S. 406, 410 (1889)).
226. *See infra* Section III.A.
227. AT&T Mobility LLC v. Concepcion, 131 S. Ct. 1740, 1746 (2011).
228. Volt Info. Scis., Inc. v. Bd. of Trs., 489 U.S. 468, 479 (1989).

III. INFORMING THE INVESTOR

A. How a Mandatory Pre-Dispute Arbitration Agreement Would Read Under the Current Legal Framework

This section of the Article provides an example of what an investor's mandatory PDAA would look like if it clearly explained not only the arbitration process, but also the legal framework governing that process:

Mandatory Arbitration Provision

I agree that by working with you, I am being forced to submit all controversies that may arise between us to binding arbitration controlled by FINRA, the organization to which you are a member. Because such agreements are so pervasive throughout the securities industry, I have little choice but to accept this agreement if I wish to have assistance in reaching my financial goals. Such controversies include, but are not limited to, those involving any transaction in any of my accounts with you, or the construction, performance or breach of any agreement between us, whether entered into or occurring prior, on or subsequent to the date hereof.

I acknowledge that the arbitration process is generally more efficient and streamlined than litigation; however, by agreeing to work with you, I am waiving certain constitutional rights, including my right to seek remedies in court and my right to due process of law. I acknowledge that pre-arbitration discovery is more limited than the discovery allowed during a court proceeding and that I am not guaranteed a hearing to articulate my claims.[229]

If I disagree with the arbitrators' award, I acknowledge that there are few options for appealing the award.[230] Even though awards must be in writing, arbitrators are not required to write reasoned opinions, provide explanations, or justify their decisions[231] and any ambiguity in the award

229. Jill I. Gross, *McMahon Turns Twenty: The Regulation of Fairness in Securities Arbitration*, 76 U. CIN. L. REV. 101, 108 (2008).

230. *See* ARW Exploration Corp. v. Aguirre, 45 F.3d 1455, 1462–63 (10th Cir. 1995) (explaining because of the courts' limited ability to review arbitration awards, their powers of review have been described as "among the narrowest known to the law."); *see* Hall St. Assocs. v. Mattel, Inc., 552 U.S. 576 (2008) (establishing that contracting parties may not opt out of FAA's default standards for vacatur and fashion their own).

231. FINRA Code of Arbitration Procedure, Rule 12904 (2014); *see* Atkinson v. Sinclair Refining Co., 370 U.S. 238 (1962) (holding the employer was not required to arbitrate its claim due to the contract); *see also* Wilko v. Swan, 346 U.S. 427, 436 (clarifying an arbitrators' "award may be made without explanation of their reasons and without a complete record of their proceedings . . .").

must be resolved, if possible, in a manner supporting confirmation of the award.[232]

Even if I can show that the arbitrators did not follow the arbitration (FINRA) rules, the Court will not overturn the award.[233] Even if I can show that the arbitrators applied the incorrect law to my case, the Court will not overturn the award.[234] Even if during the arbitration proceedings I overhear one of the arbitrators discussing his or her negative view of my case, the Court will not overturn the award.[235] Even if the arbitrator fails to disclose possible conflicts of interest and is later revealed to have had previous business contacts with the opposing party, the Court will not overturn the award.[236] Even if the arbitrators do not procure relevant documents that could have proven my case, the Court will not overturn the award.[237] Even if I can show that the arbitrators' decision was not

232. *See, e.g.*, United Paperworkers Int'l Union v. Misco, Inc., 484 U.S. 29, 38 (1987) (determining "as long as the arbitrator is even arguably construing or applying the contract and acting within the scope of his authority, that a court is convinced he committed serious error does not suffice to overturn his decision."); *see* Atl. Aviation, Inc. v. EBM Grp., Inc., 11 F.3d 1276, 1282 (5th Cir. 1994) (indicating "courts should defer to the arbitrator's resolution of the dispute whenever possible").

233. *See* Delta Mine Holding Co. v. AFC Coal Props., Inc., 280 F.3d 815, 820 (8th Cir. 2001) (explaining "only the statutory grounds in § 10(a) of the Act justify vacating an award; arbitration rules and ethical codes 'do not have force of law.'") (quoting Merit Ins. Co. v. Leatherby Ins. Co., 714 F.2d 673, 680 (7th Cir. 1983).

234. *See, e.g.*, Local 771, I.A.T.S.E. v. RKO Gen., Inc., 546 F.2d 1107, 1113 (2d Cir. 1977) (clarifying an arbitration award "will not be set aside for mistaken application of the law"); Flexible Mfg. Sys. PTY v. Super Prods. Corp. 86 F.3d 96, 100 (7th Cir. 1996) (highlighting that if "an arbitrator makes a mistake, by erroneously rejecting a valid, or even a dispositive legal defense, [it] does not provide grounds for vacating an award"); *see also* Commercial Refrigeration, Inc. v. Layton Constr. Co., 319 F. Supp. 2d 1267 (D. Utah 2004) (explaining whether the arbitrator resolved legal issue correctly is not matter for court to determine); Lagstein v. Certain Underwriters at Lloyd's, London, 607 F.3d 634, 641 (9th Cir. 2010) (clarifying that a "manifest disregard of the law" means something more than just an error in law or a failure on the part of an arbitrator to understand or apply law).

235. "Evidence of corruption must be abundantly clear in order to vacate" an arbitration award, and overheard conversation in which an arbitrator allegedly said that one party would receive a favorable decision was "not 'direct' or 'definite' evidence of bias." Kolel Beth Yechiel Mechil of Tartikov, Inc. v. YLL Irrevocable Trust, 729 F.3d 99, 100 (2d Cir. 2013).

236. *See* Gianelli Money Purchase Plan & Trust v. ADM Investor Servs., Inc., 146 F.3d 1309, 1309–10 (11th Cir. 1998) (explaining an arbitrator cannot be guilty of "evident partiality" by reason of "past business contacts between his employer" and interested party, "absent actual knowledge of a real or potential conflict"); Sphere Drake Ins. Ltd. v. All Am. Life Ins. Co., 307 F.3d 617, 623 (7th Cir. 2002) (establishing an arbitrator's "failure to make a full disclosure may sully his reputation for candor but does not demonstrate 'evident partiality' and thus does not spoil the award.").

237. *See, e.g.*, Nat'l Cas. Co. v First State Ins. Group, 430 F.3d 492, 498 (1st Cir. 2005) (explaining that where plaintiff sought to vacate arbitration award on grounds that the arbitration panel issued an award without forcing defendant company to produce relevant

supported by any evidence[238] or that the decision was arbitrary,[239] the Court will not overturn the award. I further acknowledge that even if I can show that the arbitrators made contradictory findings of fact, the Court will not overturn the award[240] and that the only way to overturn an award on the ground of "manifest disregard of the law" is to show that the arbitrators recognized the applicable law and then chose to ignore it; however, since the arbitrators are not required to provide any explanation or reasons for their decision, I recognize that this is a near-impossible hurdle.[241]

I acknowledge that I may be subject to sanctions for trying to vacate the arbitration award.[242] I further acknowledge that in the event I am successful in vacating an adverse arbitration award, I have to return to arbitration to re-litigate the matter at substantial expense, on top of the already substantial expense of bringing the vacatur action in court.[243]

In the event that I am granted an award by the arbitration panel, I acknowledge that even though FINRA rules state that "[a]ll monetary awards shall be paid within 30 days of receipt unless a motion to vacate has been filed with a court of competent jurisdiction," FINRA has no power to enforce the award,[244] other than to suspend or cancel the registration of the

documents, there was no misconduct because panel acted within its authority when it chose to render decision after drawing inferences against company as to what documents would show); Scandinavian Reinsurance Co. v. St. Paul Fire & Marine Ins. Co., 668 F.3d 60, 77 (2d Cir. 2012) (holding "[t]he FAA does not bestow on a party the right to receive information about every matter that it might consider important or useful in presenting its case.").

238. *See* Coutee v. Barington Capital Grp., L.P., 336 F.3d 1128, 1134 (9th Cir. 2003) (affirming the courts "have no authority to re-weigh the evidence" presented to the arbitration panel).

239. *See* Spungin v. GenSpring Family Offices, LLC, 883 F. Supp. 2d 1193, 1198 (S.D. Fla. 2012) (citing Hall St. Assocs., L.L.C. v. Mattel, Inc., 552 U.S. 576 (2008) (highlighting "it is apparent that an arbitration award cannot be vacated for being arbitrary and capricious."); *see also* Brabham v. A.G. Edwards & Sons, Inc., 376 F.3d 377, 382 (5th Cir. 2004) (establishing that "arbitrariness and capriciousness is not an accepted nonstatutory ground for vacatur" under the Federal Arbitration Act.).

240. *See* Bosack v. Soward, 586 F.3d 1096, 1104 (9th Cir. 2009) (explaining "[w]hether or not the panel's findings are supported by the evidence in the record is beyond the scope of our review.").

241. Dawahare v. Spencer, 210 F.3d 666, 669 (6th Cir. 2000) (citing Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Jaros, 70 F.3d 418, 421 (6th Cir.1995)) (clarifying "[a]rbitrators are not required to explain their decisions. If they choose not to do so, it is all but impossible to determine whether they acted with manifest disregard for the law.").

242. Rueter v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 440 F. Supp. 2d 1256, 1265 (N.D. Ala. 2006).

243. *See supra* note 210 and accompanying text (emphasizing the return to arbitration if original award is overturned).

244. FINRA Code of Arbitration Procedure, Rule 12904 (2014); *see* Fiero v. Fin. Indus. Regulatory Auth., Inc., 660 F.3d 569, 576 (2d Cir. 2011) (discussing the "seemingly inexplicable nature of a gap in the FINRA enforcement scheme: fines may be levied but not

broker or brokerage firm.[245] I acknowledge that I must submit a petition to confirm the arbitration award with the courts.

This arbitration agreement provides the investor with a clear articulation of the arbitration process and the laws governing that process. This author contends that if an investor reads the language of the agreement, he or she would try to amend the language to exclude the arbitration provisions or just avoid working with the advisor altogether. With the pervasive use of mandatory PDAAs in the securities industry, however, investors may find this to be an insurmountable obstacle.

IV. POSSIBLE SOLUTIONS

This section of the Article offers possible solutions for protecting investors from being forced into a dispute resolution system that they never agreed to. The solutions include ending mandatory arbitration in brokerage and advisory contracts, or providing investors with a separate disclosure document to allow the advisor to receive an investor's informed consent and allowing the investor to opt-out of arbitration. This author was heartened by the recent news that FINRA has established an arbitration task force to "consider possible enhancements to its arbitration forum to improve the transparency, impartiality and efficiency of FINRA's securities arbitration forum for all participants."[246]

A. Ending Mandatory Arbitration

The most appropriate solution to this problem is to end the practice of placing mandatory PDAAs in brokerage and advisory contracts. As stated throughout this Article, arbitration in the securities industry is not necessarily bad, and many investors would benefit from arbitration; however, investors should be given this choice.

The issue of mandatory PDAAs, in a variety of industries, has been a contested issue in Congress since the mid 1990's. Since 1995, there have been 139 anti-arbitration bills introduced in Congress; however, none of these were passed into law.[247] These include bills regarding brokerage

collected.").

245. FINRA Code of Arbitration Procedure, Rule 9554 (2014).

246. Press Release, Fin. Indus. Regulatory Auth., FINRA Announces Arbitration Task Force (July 17, 2014), *available at* http://www.finra.org/Newsroom/NewsReleases/2014/P554192.

247. Thomas V. Burch, *Regulating Mandatory Arbitration*, 2011 UTAH L. REV. 1309, 1310.

contracts, investor contracts, lending contracts, employment contracts, and many more.[248]

Some members of Congress have decided that they need to take action against these clauses in the securities industry, which they argue are unfair to investors who must forfeit their right to "their day in court" in order to obtain the professional services of a broker or investment adviser. In an interview with *InvestmentNews*, Rep. Keith Ellison (D-MN), a member of the House Financial Services Committee, stated that "[i]nvestors shouldn't have to sign away their rights in order to work with a financial adviser or broker dealer to build a secure retirement. By removing some of the unfair advantages, consumers will be more eager to invest, which will create jobs and strengthen the economy."[249]

Rep. Ellison introduced the Investor Choice Act of 2013 to address pre-dispute mandatory arbitration in brokerage and advisory agreements.[250] The purpose of the bill is to "amend the Securities Exchange Act of 1934 to prohibit mandatory pre-dispute arbitration agreements, and for other purposes."[251] In summary, the bill would make it unlawful for brokers, advisers, and certain other financial services professionals to mandate pre-dispute arbitration of claims and to prevent investors from seeking redress through class action lawsuits.[252]

It is important to note that even though Congress is looking at the issue of mandatory PDAAS in the securities industry, the SEC already has the authority to mandate that individuals and companies no longer use these clauses in their contracts. Section 921 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") authorized the SEC to adopt regulations to ban, condition, or limit mandatory arbitration clauses.[253] This also allows FINRA to amend its rules concerning mandatory arbitration, because the SEC must approve any FINRA proposed rule. As of the date of this Article, no action has been taken.

This inaction on the part of the SEC is surprising, especially since over thirty years ago, in 1979, the SEC "expressed concern about the use of arbitration clauses in broker-dealer customer agreements which purport to

248. *See id.* (including appendix listing all 139 bills and a summary of the bills and their status).

249. Mark Schoeff, *House Democrat Introduces Bill to End Mandatory Arbitration*, INVESTMENTNEWS, (Aug. 5, 2013, 2:59 PM), https://www.investmentnews.com/article/20130805/FREE/130809965?template=printart.

250. Investor Choice Act of 2013, H.R. 2998, 113th Cong. (2013).

251. *Id.* at 1.

252. *Id.* at 1–2.

253. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 921, 124 Stat. 1376, 1841 (2010).

bind customers to arbitrate all future disputes with a broker-dealer."[254] In the Release, the SEC explicitly stated that:

> [t]he Commission believes that the use of clauses which purport to bind customers to arbitrate all future disputes which may arise between them and their broker-dealers, without specifying the meaning, effect and enforceability thereof, *is inconsistent with just and equitable principles of trade*, and may raise serious questions of compliance with the anti-fraud provisions of the federal securities laws.[255]

The Senate has also recently asked the SEC to investigate the use of mandatory PDAAs in their most recent appropriations bill: "[t]he Committee directs that the SEC prioritize, initiate, and complete critical rulemakings to address . . . limiting use of mandatory arbitration agreements in brokerage customer service agreements . . . ."[256] This request reflects Congressional interest in understanding the impact of PDAAs in the financial services industry.

B. Informed Consent and Opt-Out Provision

The second option is to mandate that financial service providers obtain investors' informed consent before signing the advisory or brokerage agreement and allowing the investor to "opt-out" of the pre-dispute arbitration agreement. This can be handled by two different methods. The first method is for the financial service provider to furnish the investor with an arbitration document, separate from the contract, which describes the arbitration process (including options for appeal) at the beginning of the client relationship. The second method is for the financial service provider to deliver this document to the investor once a dispute arises and, at that time, the investor can make an informed decision whether to enter into arbitration. Both of these methods require an investor to choose a single method of dispute resolution. For example, an investor cannot choose litigation, but then ask for arbitration if the investor is losing in court.

Under this method, investors have the choice of arbitration or litigation. Currently, investors are generally notified by a clause buried in the boilerplate language of a brokerage or advisory contract or lengthy

254. Notice to Broker-Dealers Concerning Clauses in Customer Agreements which Provide for Arbitration of Future Disputes, Exchange Act Release No. 15,984, 1979 WL 174165, at *1 (July 2, 1979).
255. *Id.* (emphasis added).
256. 2015 APPROPRIATIONS BILL, *supra* note 5, at 132.

disclosure document. By requiring informed consent, an investor will be provided with all the information he or she needs to make an informed decision and will not have to suffer due to a clause, which he or she was not aware of, buried in a contract or long disclosure document.

CONCLUSION

An overwhelming majority of retail brokerage, and many investment advisory agreements, include language requiring that all disputes between the customer and the broker-dealer/investment adviser be resolved through arbitration, and only in rare instances can an investor open either a brokerage or investment advisory account without agreeing to submit to mandatory pre-dispute arbitration.

This Article has provided ample evidence that mandatory PDAAs force investors to relinquish certain constitutional rights. This Article has also provided ample evidence that there is effectively no appellate review of arbitration awards and that it is virtually impossible for an investor to overturn an erroneous award. As noted above, some investor claims are appropriate for arbitration; however, the choice should belong to the investor. The SEC has the authority to ban these types of agreements; however, no action has been taken. Until these types of agreements are banned from the industry, investors will continue to be forced into a dispute resolution system that lacks transparency, requires the investor to relinquish certain constitutional rights, and lacks any effective mechanism to correct erroneous decisions.