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ENFORCING ARBITRATION OF FEDERAL SECURITIES
LAW CLAIMS: THE EFFECT OF *DEAN WITTER*
REYNOLDS, INC. v. BYRD

When investors open accounts with securities brokers, they usually sign a standard brokerage contract. These contracts generally contain an arbitration agreement,¹ in which the investor forfeits the right to sue the broker by agreeing to submit any disputes to binding arbitration. Although agreements to arbitrate future disputes generally are enforceable under the United States Arbitration Act,² federal courts have been unwilling to compel arbitration when an investor alleges violations of federal securities laws. In particular, courts have permitted investors to sue brokers for violations of section 10(b) of the Securities Exchange Act of 1934³ and rule 10b-5⁴ despite contrary terms in the arbitration agreement.

1. A representative agreement reads:

It is agreed that any controversy between us arising out of . . . this agreement shall be submitted to arbitration conducted under the provisions of the Constitution and Rules of the Board of Governors of the New York Stock Exchange or pursuant to the Code of Arbitration of the National Association of Securities Dealers, as the undersigned may elect.

Brener v. Becker Paribas, Inc., 628 F. Supp. 442, 445 (S.D.N.Y. 1985).

2. 9 U.S.C. §§ 1-14 (1982). Section 2 of the Act provides: "A written provision in . . . a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." *Id.* at § 2; see also Katsoris, *The Arbitration of a Public Securities Dispute*, 53 *FORDHAM L. REV.* 279, 292 & n.88 (1984).

3. 15 U.S.C. § 78j (1982). Known as the anti-fraud provision, § 10(b) provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

. . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Id.

4. 17 C.F.R. § 240.10b-5 (1985). Rule 10b-5, promulgated pursuant to § 10(b), defines activities which violate § 10(b). The rule provides:

This conflict between rights to sue created under federal securities laws and waivers of those rights in arbitration agreements is some thirty years old. Since the Supreme Court decided *Wilko v. Swan*⁵ in 1953, federal courts have held that the Securities Exchange Act of 1934⁶ as well as the Securities Act of 1933⁷ guarantee investors the right to sue brokers in federal court—without regard to an arbitration agreement.⁸ The Court premised its decision in

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality, of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

5. 346 U.S. 427 (1953).

6. 15 U.S.C. §§ 78a-78kk (1982). Most investors bring claims under the Exchange Act rather than the Securities Act, 15 U.S.C. §§ 77a-77aa (1982). The Exchange Act regulates post-issuance securities trading, which includes the usual investor-broker transactions. The Securities Act applies to the initial issuance of securities, in which individual investors generally do not participate. Investors rely primarily on rule 10b-5 in particular because it covers many of the limitless possibilities for fraudulent activities relating to investment securities.

7. 15 U.S.C. §§ 77a-77aa (1982).

8. In *Wilko* the Court guaranteed investors the right to sue under § 12(2) of the Securities Act, 346 U.S. at 438; see *infra* text accompanying notes 18-20. Section 12(2) provides expressly for private damage remedies. See Pub. L. No. 73-22 § 12(2), 48 Stat. 74, 84 (codified as amended at 15 U.S.C. § 77l(2) (1982)).

The Exchange Act provides for private damage remedies in three provisions:

Section 9(e) . . . confers a private right of action upon an injured investor against one who has willfully engaged in market manipulation of securities subject to the 1934 Act's registration and reporting requirements by virtue of being listed on a national exchange. [15 U.S.C. § 78i(e) (1982)] Section 18(a) . . . sets out a private right of action for an investor who has been injured due to reliance on materially misleading statements or omissions of material facts in documents required to be filed with the commission. [15 U.S.C. § 78r(a) (1982)] Section 16(b)'s disgorgement of insider short-swing profits is the third express private remedy [15 U.S.C. § 78p(b) (1982)] . . .

T. HAZEN, *THE LAW OF SECURITIES REGULATION* § 13.2 (1985).

Section 10(b) of the Exchange Act does not provide for a private damage remedy. See 15 U.S.C. § 78j (1982); *supra* note 3. Federal courts, however, have recognized an implied private remedy based on this section and rule 10b-5 for nearly 40 years. See, e.g., *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1970); *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946); *infra* text accompanying notes 31-35. Significantly, a con-

Wilko on the notion that the investor-protection policy underlying the Securities Act of 1933 outweighed the competing policy of promoting arbitration of commercial disputes embodied in the Arbitration Act.⁹

In 1985, however, the Supreme Court called into question the longstanding application of *Wilko* to the Securities Exchange Act of 1934. Even though the decision in *Dean Witter Reynolds, Inc. v. Byrd*¹⁰ did not address directly the enforcement of arbitration agreements in disputes involving 1934 Act claims, the Court, in dicta, and Justice White, in his concurrence, implied that arbitration agreements may be enforceable against investors alleging section 10(b) and rule 10b-5 violations.¹¹ Almost immediately, federal courts began relying on *Byrd* to compel arbitration of section 10(b) and rule 10b-5 claims.¹² The number of courts enforcing agreements grew rapidly, although a substantial minority of district courts continued to refuse to compel arbitration. In April 1986, the *Byrd*-induced wave of arbitration cases first reached the appellate level. Reversing the trend among the lower courts, five circuit courts held that federal courts could not require arbitration of rule

tinuous line of circuit court decisions has extended *Wilko*'s guarantee of a right of action for investors subject to arbitration agreements to section 10(b) and rule 10b-5 claims.

Courts also have recognized implied rights of action under sections 14(a) and 14(e) of the Exchange Act. 15 U.S.C. §§ 78n(a), (e) (1982). Section 14(a) is similar to section 10(b) in that the rules promulgated by the Securities and Exchange Commission define statutory violations. As section 14(a) regulates the solicitation of proxies, rule 14a-9 prohibits material misstatements, omissions, and fraud in connection with the solicitation of proxies. 17 C.F.R. § 240.14a-9. The private damage action under section 14(a) arises for violation of rule 14a-9. See, e.g., *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964).

Section 14(e), which prohibits material misstatements, omissions, and fraudulent practice in connection with tender offers, differs from both sections 10(b) and 14(a) in that the statute is self-executing; violations of rules are unnecessary for statutory violations. See 15 U.S.C. § 78n(e) (1982). Although shareholders and management of target companies may seek relief under section 14(e), see, e.g., *Schlesinger Inv. Partnership v. Fluor Corp.*, 671 F.2d 739 (2d Cir. 1982) (shareholder damage suit); *Prudential Real Estate Trust v. John-camp Realty*, 599 F.2d 1140 (2d Cir. 1979) (management suit for injunctive relief), competing offerors lack standing to sue. *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977).

This Note concentrates on the implied right of action under section 10(b) and rule 10b-5, as the actions under sections 14(a) and 14(e) generally do not arise in the investor-broker context.

9. 346 U.S. at 438.

10. 470 U.S. 213 (1985).

11. *Id.* at 215 n.1; *Id.* at 225 (White, J., concurring).

12. See *infra* notes 63-66 and accompanying text.

10b-5 claims.¹³ Only two circuit courts enforced agreements to arbitrate such claims.¹⁴ As the divergence among district and circuit courts indicates, the *Byrd* decision created fundamental uncertainty. *Byrd* has reopened debate between the two powerful competing public policies of investor protection and efficient dispute resolution. To resolve this conflict, the Supreme Court recently granted certiorari in *McMahon v. Shearson/American Express, Inc.*¹⁵

This Note traces briefly the development of the *Wilko* doctrine denying enforcement of arbitration agreements in investor-broker disputes. It then analyzes the challenge to *Wilko* raised in *Byrd* and its progeny, and evaluates the legal and policy arguments concerning arbitration of section 10(b) and rule 10b-5 claims. The Note concludes that federal courts should not be lured into enforcing arbitration agreements for the sake of efficiency. They instead should continue to follow the longstanding precedent guaranteeing investors the right to bring Securities Exchange Act claims in federal court. The Note proposes that Congress amend the Securities Exchange Act of 1934 to create an express private right of action for Securities Exchange Act claims. The amended statute should provide also that an arbitration agreement would be enforceable only if the agreement were optional, if the broker fully apprised the investor of the federal rights he or she waived by signing, and if the size of a subsequent dispute failed to meet a specified minimum dollar amount.

13. See *Jacobson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 797 F.2d 1197 (3d Cir. 1986); *King v. Drexel Burnham Lambert, Inc.*, 796 F.2d 59 (5th Cir. 1986), *petition for cert. filed*, 55 U.S.L.W. 3152 (U.S. Aug. 25, 1986) (No. 86-282); *Conover v. Dean Witter Reynolds, Inc.*, 794 F.2d 520 (9th Cir. 1986); *Miller v. Drexel Burnham Lambert, Inc.*, 791 F.2d 850 (11th Cir. 1986); *McMahon v. Shearson/Am. Express, Inc.*, 788 F.2d 94 (2d Cir.), *cert. granted*, 107 S. Ct. 60 (1986).

14. *Page v. Moseley, Hallgarten, Estabrook & Weeden, Inc.*, 806 F.2d 291 (1st Cir. 1986); *Phillips v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 795 F.2d 1393 (8th Cir. 1986) (2-1 decision).

15. 788 F.2d 94 (2d Cir.), *cert. granted*, 107 S. Ct. 60 (1986). Petitions for certiorari were filed in *King v. Drexel Burnham Lambert, Inc.*, 796 F.2d 59 (5th Cir. 1986), *petition for cert. filed*, 55 U.S.L.W. 3152 (U.S. Aug. 25, 1986) (No. 86-282), and *Intre Sport Ltd. v. Kidder, Peabody & Co.*, 625 F. Supp. 1303 (S.D.N.Y.), *aff'd without opinion*, 795 F.2d 1004 (2d Cir. 1985), *petition for cert. filed*, 55 U.S.L.W. 3023 (U.S. July 16, 1986) (No. 86-40).

THE *Wilko* DOCTRINE

In *Wilko v. Swan*,¹⁶ the Supreme Court faced the issue of whether the Securities Act of 1933 invalidated arbitration agreements between investors and brokers. Section 12(2) guarantees an investor's right to sue his or her broker in federal court for making false and misleading statements relating to the sale of a security in a public offering.¹⁷ The question in *Wilko* was whether the defendant broker could avoid litigation by invoking an arbitration agreement his customer signed at the beginning of their relationship.

The Court refused to enforce the agreement, relying on section 14 of the Act, which provides that "[a]ny condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter . . . shall be void."¹⁸ The Court reasoned that "the right to select a judicial forum is the kind of 'provision' that cannot be waived under section 14 of the Securities Act."¹⁹ Enforcing an arbitration agreement forces an investor to surrender the section 12(2) right to sue the broker, thus violating section 14. The Court therefore invalidated such agreements.²⁰

The Court in *Wilko* emphasized Congress's reasons for guaranteeing investors the right to sue brokers. Individual investors typically suffer from a weak bargaining position when dealing with brokers. Investors usually know less about the risks involved in securities transactions and so are less able to anticipate the likelihood of a dispute.²¹ In addition, because they must sign an arbitration agreement before doing business, investors cannot determine the advantages they surrender by waiving the right to sue the bro-

16. 346 U.S. 427 (1953).

17. Section 12(2) provides that the seller of a security "shall be liable to the person purchasing such security" if he or she offers or sells the security by means of "an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading." Securities Act of 1933, § 12(2), Pub. L. No. 73-22, 48 Stat. 74, 84 (codified as amended at 15 U.S.C. § 77l(2) (1982)).

18. *Id.* at § 77n.

19. 346 U.S. at 435.

20. *Id.* at 438.

21. *Id.* at 435.

ker; investors cannot foresee whether arbitration or legal action will better serve their interests in a future dispute.²²

At a policy level, *Wilko* represented a confrontation between two opposing public interests: efficient dispute resolution, as embodied in the Arbitration Act, and investor protection, as provided by the Securities Act of 1933.²³ In the Arbitration Act, Congress sought to encourage settlement of commercial disputes by arbitration.²⁴ Congress recognized that arbitration is usually less costly and less time-consuming than litigation and that arbitration lightens the judicial case load. The Arbitration Act explicitly reverses the traditional judicial reluctance to enforce arbitration agreements.²⁵ Under the Act, agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."²⁶

The Securities Act of 1933, on the other hand, resolves investor-broker disputes through litigation. Congress believed that the safeguards of a trial are necessary to protect customers from the serious harm that could result from securities fraud.²⁷ By barring enforcement of arbitration agreements, the Court in *Wilko* resolved this conflict of policies in favor of the Securities Act, creating an exception to the nonjudicial dispute resolution favored in the Arbitration Act.²⁸

22. *Id.*

23. *Id.* at 438. Professor Louis Loss, in his treatise on securities regulation, observed that *Wilko* "presented a neat conflict between two socially desirable policies—arbitration with its advantages of speed and economy, and protection of the rights of investors against persons with superior bargaining power." L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 1192 (1983).

24. H.R. REP. NO. 96, 68th Cong., 1st Sess. 1-2 (1924). The Supreme Court has affirmed this "liberal federal policy favoring arbitration" on several occasions. *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983); *accord Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 105 S. Ct. 3346, 3353-54 (1985).

25. *Mitsubishi*, 105 S. Ct. at 3353-54.

26. 9 U.S.C. § 2 (1982).

27. S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933). The Court made this point in *Wilko*. 346 U.S. at 430-31.

28. 346 U.S. at 438.

AFTER *Wilko*

Federal courts have recognized a private cause of action under rule 10b-5 since 1947.²⁹ Now firmly embedded in federal securities law, the private cause of action arose from judicial cognizance of congressional intent to provide investors complete relief from the proscribed activities.³⁰ Eventually, the Supreme Court approved the overwhelming tide of lower court precedent recognizing private remedies under rule 10b-5.³¹

At the same time that private remedies under rule 10b-5 began to develop, a majority of federal circuit courts held also that *Wilko* guaranteed investors subject to an otherwise enforceable arbitration agreement the right to assert rule 10b-5 claims in federal courts.³² These cases dramatically extended *Wilko*'s reach because the bulk of securities litigation now involves investor claims alleging violations of rule 10b-5. The courts reasoned that the non-waiver provision of the Securities Exchange Act of 1934³³ protected

29. *E.g.*, *Surman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 733 F.2d 59 (8th Cir. 1984); *Delancie v. Birr, Wilson & Co.*, 648 F.2d 1255 (9th Cir. 1981); *Mansbach v. Prescott, Ball & Turban*, 598 F.2d 1017 (6th Cir. 1979); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Moore*, 590 F.2d 823 (10th Cir. 1978); *Allegaert v. Perot*, 548 F.2d 432 (2d Cir.), *cert. denied*, 432 U.S. 910 (1977); *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831 (7th Cir. 1977); *Sibley v. Tandy Corp.*, 543 F.2d 540 (5th Cir. 1976), *cert. denied*, 434 U.S. 824 (1977); *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532 (3d Cir.), *cert. denied*, 429 U.S. 1010 (1976); *see also* Katsoris, *supra* note 2, at 297-98; Krause, *Securities Litigation: The Unsolved Problem of Predispute Arbitration Agreements for Pendent Claims*, 29 DE PAUL L. REV. 693, 704 (1980); Note, *The Severability of Arbitrable and Nonarbitrable Securities Claims*, 41 WASH. & LEE L. REV. 1165, 1172 (1984).

30. *E.g.*, *Ayres*, 538 F.2d at 536 (waiver of the right to trial is inconsistent with Congress's investor protection policy expressed in both the 1933 and 1934 Acts); *see also* Reader v. Hirsch & Co., 197 F. Supp. 111, 114-15 (S.D.N.Y. 1961) (Congress's 1933 Act intention to provide investors with a private right of action carries over to the 1934 Act).

31. *E.g.*, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976) (citing earlier cases) ("the existence of a private cause of action for violations of [§ 10(b)] and . . . Rule [10b-5] is now well established."); *see also* L. Loss, *supra* note 23, at 1195.

32. *See, e.g.*, *Surman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 733 F.2d 59 (8th Cir. 1984); *Delancie v. Birr, Wilson & Co.*, 648 F.2d 1255 (9th Cir. 1981); *Mansbach v. Prescott, Ball & Turban*, 598 F.2d 1017 (6th Cir. 1979); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Moore*, 590 F.2d 823 (10th Cir. 1978); *Allegaert v. Perot*, 548 F.2d 432 (2d Cir.), *cert. denied*, 432 U.S. 910 (1977); *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831 (7th Cir. 1977); *Sibley v. Tandy Corp.*, 543 F.2d 540 (5th Cir. 1976), *cert. denied*, 434 U.S. 824 (1977); *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532 (3d Cir.), *cert. denied*, 429 U.S. 1010 (1976).

33. 15 U.S.C. § 77n (1982).

the implied right of action against the effect of an arbitration agreement, as much as if Congress had granted the right textually.³⁴ Accordingly, these courts refused to enforce arbitration of 10(b) and 10b-5 claims.

Congress tacitly approved this judicial interpretation of its intent in 1975, when the House and Senate undertook a comprehensive revision of the Securities Exchange Act. A conference committee report stated plainly that Congress believed *Wilko* applied to the Exchange Act and prohibited enforcement of arbitration agreements in 10(b) and 10b-5 claims. "[T]he clear understanding of the conferees [was] that this amendment did not change existing law, as articulated in *Wilko v. Swan*, concerning the effect of arbitration proceeding provisions in agreements entered into by persons dealing with members and participants of self-regulatory organizations."³⁵

For many years the Supreme Court also tacitly recognized the circuit courts' extension of *Wilko* to the Securities Exchange Act by repeatedly denying certiorari in lower court cases that extended *Wilko* to the Exchange Act.³⁶ The Court's refusal to consider the issue enabled the lower federal courts to develop a substantial body of case law denying enforcement of arbitration agreements in claims brought under section 10(b) and rule 10b-5.³⁷

The Supreme Court finally addressed the conflict between the implied right of action and the enforceability of arbitration agreements in *Scherk v. Alberto-Culver Co.*³⁸ In *Scherk*, the parties had signed an arbitration agreement prior to engaging in an international commercial transaction. The Court enforced the parties' arbitration agreement because the international dispute would have been very difficult to settle otherwise.³⁹ Although it did not decide

34. See, e.g., *Sibley*, 543 F.2d at 543 n.3; *Ayres*, 538 F.2d at 536-37.

35. H.R. CONF. REP. No. 229, 94th Cong., 1st Sess. 111 (1975), reprinted in 1975 U.S. CODE CONG. & ADMIN. NEWS 321, 342 (citation omitted); see Stansbury & Klein, *The Arbitration of Investor-Broker Disputes: A Summary of Developments*, 35 ARB. J. 30, 35 (Sept. 1980).

36. E.g., *Allegaert v. Perot*, 548 F.2d 432 (2d Cir.), cert. denied, 432 U.S. 910 (1977); *Sibley v. Tandy Corp.*, 543 F.2d 540 (5th Cir. 1976), cert. denied, 434 U.S. 824 (1977); *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532 (3d Cir.), cert. denied 429 U.S. 1010 (1976).

37. Stansbury & Klein, *supra* note 35, at 34.

38. 417 U.S. 506 (1974).

39. *Id.* at 515-16.

the question directly, the Court also implied in dicta that the *Wilko* holding should not extend to the Exchange Act. The Court emphasized that the 1934 Act did not create expressly a private right of action as the 1933 Act did in section 12(2).⁴⁰ Accordingly, the Court indicated that even though federal case law had established an implied right of action for section 10(b) and rule 10b-5 claims, that right was not a "provision" of the Exchange Act to which the nonwaiver provision of the Act, section 29(a), applied.⁴¹

Lower federal courts, however, did not follow the Court's suggestion that *Wilko* did not extend to the Exchange Act. The courts usually distinguished *Scherk* on the grounds that it concerned an international transaction.⁴² The lower courts acknowledged the Supreme Court's dictum pointing out the differences in the terms of the 1933 and 1934 Acts.⁴³ They nevertheless concluded that the similarities between the Acts outweighed their differences, and therefore continued to hold that *Wilko* prohibited enforcement of arbitration agreements in connection with Exchange Act claims.⁴⁴

40. *Id.* at 513.

41. *Id.* at 514.

42. "The position of the plaintiff in the instant suit, however, can hardly be analogized to the posture of Alberto-Culver Company. The contract signed was defendant's 'Standard Option Agreement' and there are no international considerations at play as were present in *Scherk*." *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831, 835 (7th Cir. 1977).

43. *E.g.*, *Weissbuch*, 558 F.2d at 835; *Sibley*, 543 F.2d at 543.

44. Although a "'colorable argument can be made' that *Wilko* . . . should not apply to arbitration of judicially implied causes of action under the 1934 Act . . . [w]e are not . . . persuaded that either the differences between the rights granted in the 1933 and 1934 Acts or any consideration of policy warrant such a distinction." *Ayres*, 538 F.2d at 536 (quoting *Scherk*, 417 U.S. at 513).

Despite having declined to enforce standard investor-broker arbitration agreements, federal courts have carved out exceptions to the *Wilko* doctrine. See L. Loss, *supra* note 23, at 1193-94. *Wilko* applies only to predispute agreements. It does not prevent enforcement of an agreement to arbitrate an existing dispute. *E.g.*, *Malena v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,492 (E.D.N.Y. Apr. 18, 1984); see also *Katsoris*, *supra* note 2, at 295. An investor choosing to arbitrate an existing dispute is in a better position to assess the value of arbitration than an investor who agrees to arbitrate in advance of any dispute. Also, *Wilko* does not prevent enforcement of agreements when the investor is experienced in securities trading and the parties deal at arm's length. *Alco Standard Corp. v. Benalal*, 345 F. Supp. 14, 24 (E.D. Pa. 1972); see L. Loss, *supra* note 23, at 1194; *Krause*, *supra* note 29, at 703 n.58; *Peloso*, *Agreements to Arbitrate*, 13 REV. SEC. REG. 943, 946-47 (1980). An investor with business sophistication is able to make an informed choice whether to waive his or her federal right of action by signing an arbitration agreement. Neither of these exceptions, however, alters *Wilko*'s application to

DEAN WITTER REYNOLDS, INC. v. BYRD

In *Dean Witter Reynolds, Inc. v. Byrd*,⁴⁵ the Supreme Court again has questioned the circuit court precedent barring enforcement of arbitration agreements in Exchange Act claims. Although the Court did not address the issue directly, the majority opinion, and especially Justice White's concurring opinion, cast doubt on *Wilko*'s applicability to causes of action under the 1934 Act.

The issue in *Byrd* was whether to compel arbitration of state securities law claims pendent to federal claims under the Exchange Act.⁴⁶ Byrd sued in the United States District Court for the Southern District of California, alleging violations of sections 10(b), 15(c), and 20 of the Exchange Act, as well as state-law violations.⁴⁷ He claimed that Dean Witter Reynolds, Inc., had "churned"⁴⁸ his account. When he invested with the defendant, Byrd had signed an agreement that contained a standard provision mandating arbitration of any future controversy arising out of the contract. Dean Witter relied on this agreement in its motion to sever Byrd's state claims and compel their arbitration, and to stay arbitration until the court resolved Byrd's Exchange Act claims.⁴⁹

Prior to *Byrd* the circuit courts had split over whether to sever federal and state securities fraud claims in order to allow arbitration of state claims pendent to inarbitrable federal claims. Three circuits endorsed a doctrine of severance and ordered arbitration of the state claims when the parties had signed an arbitration agreement.⁵⁰ Three other circuits held that when federal and state

the majority of Exchange Act claims, which involve agreements signed in advance by inexperienced investors.

45. 470 U.S. 213 (1985).

46. *Id.* at 214.

47. Byrd invested \$160,000 with Dean Witter in 1981. Within an eight-month period Byrd lost \$100,000. *Id.*

48. "Churning occurs when a securities broker enters into transactions and manages a client's account for the purpose of generating commissions and in disregard of his client's interests." *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 324 (5th Cir. 1981).

49. 470 U.S. at 215.

50. See *Surman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 733 F.2d 59 (8th Cir. 1984); *Liskey v. Oppenheimer & Co.*, 717 F.2d 314 (6th Cir. 1983); *Dickinson v. Heinold Sec., Inc.*, 661 F.2d 638 (7th Cir. 1981).

claims are intertwined sufficiently, federal courts should deny arbitration of the state claims and try all the claims together.⁵¹

In *Byrd*, the Supreme Court resolved the split in favor of severance. It held that district courts must enforce arbitration agreements with respect to pendent state-law claims.⁵² *Byrd*'s primary significance with respect to the enforcement of arbitration agreements in Exchange Act claims lies in its dicta. In a footnote outlining the development of the *Wilko* doctrine, the Court observed that "the question whether *Wilko* applies to section 10(b) and Rule 10b-5 claims is not properly before us."⁵³ Because Dean Witter had not attempted to compel arbitration of *Byrd*'s Exchange Act claims, the Court declined to resolve the question.⁵⁴ Justice White, however, developed this "question" in an influential concurrence.

Justice White asserted that *Wilko*'s prohibition of arbitration of investor claims under the Securities Act "cannot be mechanically transplanted to the 1934 Act."⁵⁵ He acknowledged that both the 1933 and 1934 Acts contain nonwaiver provisions; section 14 of the Securities Act and section 29(a) of the Exchange Act void any agreement by which an investor surrenders any right created by other provisions of the Act.⁵⁶ Two other key provisions of the Securities Act, however, "are imperfect or absent altogether" in the Exchange Act.⁵⁷ The 1934 Act limits jurisdiction for claims to federal court, whereas the 1933 Act creates state court jurisdiction as well.⁵⁸ More importantly, Justice White emphasized, the Exchange Act does not authorize explicitly a private cause of action for in-

51. See *Byrd v. Dean Witter Reynolds, Inc.*, 726 F.2d 552 (9th Cir. 1984), *rev'd*, 470 U.S. 213 (1985); *Belke v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 693 F.2d 1023 (11th Cir. 1982); *Miley v. Oppenheimer & Co.*, 637 F.2d 318 (5th Cir. 1981).

52. 470 U.S. at 218.

53. *Id.* at 215 n.1.

54. *Id.* at 215.

55. *Id.* at 224-25 (White, J., concurring).

56. *Id.* at 224.

57. *Id.* at 224-25. Justice White was repeating the Court's observations from *Scherk*.

58. Compare Exchange Act § 27, 15 U.S.C. § 78aa (1982) ("The district courts of the United States . . . shall have exclusive jurisdiction of violations of this chapter. . . .") with Securities Act § 22(a), 15 U.S.C. § 77v(a) (1982) ("The district courts of the United States . . . shall have jurisdiction, concurrent with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by this subchapter.").

vestors.⁵⁹ Building upon doubts first expressed in *Scherk v. Alberto-Culver Co.*,⁶⁰ Justice White noted that denial of implied investor rights of action under the Exchange Act through enforcement of arbitration agreements does not abrogate any provision of the Act.⁶¹ He concluded that the question of whether *Wilko* prevents arbitration of 1934 Act claims "remains open and the contrary holdings of the lower courts must be viewed with some doubt."⁶²

THE INITIAL REACTION: CONFUSION IN THE DISTRICT COURTS

Byrd resulted in a flurry of activity in federal district courts. Soon after the decision, a majority of district courts applied *Byrd* to enforce agreements to arbitrate 10(b) and 10b-5 claims, often breaking with circuit court precedent.⁶³ After tracing the develop-

59. 470 U.S. at 224-25 (White, J., concurring).

60. 417 U.S. 506 (1974); see *supra* text accompanying notes 38-41.

61. 470 U.S. at 225 (White, J., concurring).

62. *Id.*

63. See, e.g., *Fisher v. Prudential-Bache Sec., Inc.*, 635 F. Supp. 234 (D. Md. 1986); *Baker v. Paine, Webber, Jackson & Curtis, Inc.*, 637 F. Supp. 419 (D.N.J. 1986); *Shotto v. Laub*, 632 F. Supp. 516 (D. Md. 1986); *Sulit v. Dean Witter Reynolds, Inc.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 92,755 (Mar. 27, 1986); *Brener v. Becker Paribas, Inc.*, 628 F. Supp. 442 (S.D.N.Y. 1985); *Ilan v. Shearson/Am. Express, Inc.*, 632 F. Supp. 886 (S.D.N.Y. 1985); *Moncrieff v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 623 F. Supp. 1005 (E.D. Mich. 1985); *Finkle & Ross v. A.G. Becker Paribas, Inc.*, 622 F. Supp. 1505 (S.D.N.Y. 1985); *Prawer v. Dean Witter Reynolds, Inc.*, 626 F. Supp. 642 (D. Mass. 1985); *Geller v. Nasser*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,409 (C.D. Cal. Nov. 18, 1985); *Peele v. Kidder, Peabody & Co.*, 620 F. Supp. 61 (W.D. Mo. 1985); *Ross v. Mathis*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,343 (N.D. Ga. Sept. 11, 1985); *Land v. Dean Witter Reynolds, Inc.*, 617 F. Supp. 55 (E.D. Va. 1985); *Marx v. Dean Witter Reynolds, Inc.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,311 (C.D. Cal. Aug. 23, 1985); *West v. Drexel Burnham Lambert, Inc.*, 623 F. Supp. 26 (W.D. Wash. 1985); *Jarvis v. Dean Witter Reynolds, Inc.*, 614 F. Supp. 1146 (D. Vt. 1985); *Johnson v. Kidder, Peabody & Co.*, No. 85 CV-178 (N.D.N.Y. July 30, 1985); *Colangelo v. Dean Witter Reynolds, Inc.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,365 (M.D. Fla. July 23, 1985); *Walch v. Dean Witter Reynolds, Inc.*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,060 (M.D. Fla. Apr. 25, 1985); *Hashemi v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. C82-2948A (N.D. Ga. July 31, 1985); *Dees v. Distenfield*, 618 F. Supp. 123 (C.D. Cal. 1985); *Driscoll v. Smith Barney, Harris Upham & Co.*, 625 F. Supp. 25 (S.D. Fla. 1985); *Ackerman v. Drexel Burnham Lambert, Inc.*, No. 84-6737-Civ (S.D. Fla. May 14, 1985); *Sevinor v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 84-3240-N (D. Mass. July 19, 1985); *Coonly v. Rotan Mosle, Inc.*, 630 F. Supp. 404 (W.D. Tex. 1985); *Westwind Transp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 84-734 Civ-T10 (M.D. Fla. Apr. 19, 1985); *Boyd v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 611 F. Supp. 218 (S.D. Fla.), *on reh'g*,

ment of the *Wilko* doctrine through the *Byrd* decision, the courts characteristically rested their holdings on two points: Justice White's argument that *Wilko's* reasoning could not be extended to the Exchange Act because the 1934 Act lacked a counterpart to section 12(2) of the 1933 Act, which creates an express private right of action;⁶⁴ and recent Supreme Court decisions affirming the "strong national policy favoring arbitration."⁶⁵ These lower courts therefore interpreted the *Byrd* decision, and especially Justice White's concurrence in that decision, as articulating a preference for enforcement of investor-broker arbitration agreements in claims based on an implied right of action under the 1934 Act.⁶⁶

A minority of district courts disagreed, however, and continued to deny enforcement of arbitration agreements.⁶⁷ These courts pointed out that in *Byrd*, as both the Court and Justice White had

614 F. Supp. 940 (S.D. Fla. 1985); Houlihan v. John Schmacker & Smith, Moore & Co., 621 F. Supp. 48 (E.D. Mo. 1985); Finn v. Davis, 610 F. Supp. 1079 (S.D. Fla. 1985); Mann v. Foster & Marshall/Am. Express, Inc., No. C84-925D (W.D. Wash. June 3, 1985); Greenstein v. First Biscayne Corp., No. 82-0584-Civ (S.D. Fla. May 16, 1985); Raiford v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,269 (N.D. Ga. May 16, 1985); Niven v. Dean Witter Reynolds, Inc., [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,059 (M.D. Fla. Mar. 28, 1985); Gregory v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 84-1647-T-10 (M.D. Fla. Mar. 9, 1985).

64. *E.g.*, *Ilan v. Shearson/Am. Express, Inc.*, 632 F. Supp. 886, 889 (S.D.N.Y. 1985); *Moncrieff v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 623 F. Supp. 1005, 1007 (E.D. Mich. 1985); *Prawer v. Dean Witter Reynolds, Inc.*, 626 F. Supp. 642, 645 (D. Mass. 1985).

65. *E.g.*, *Ilan*, 632 F. Supp. at 888; *Moncrieff*, 623 F. Supp. at 1006-07; *Prawer*, 626 F. Supp. at 646.

66. *See, e.g.*, *Moncrieff v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 623 F. Supp. 1005 (E.D. Mich. 1985); *Raiford v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,269 (N.D. Ga. May 16, 1985).

67. *See, e.g.*, *Kennedy v. Sheets*, 18 Sec. Reg. & L. Rep. (BNA) 1169 (W.D.N.Y. July 23, 1986); *Hubbard v. Shearson/Am. Express, Inc.*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 92,869 (W.D.N.Y. July 15, 1986); *Kalali v. Prudential-Bache Sec., Inc.*, 637 F. Supp. 1131 (D.D.C. 1986); *Bustamante v. Rotan Mosle, Inc.*, 633 F. Supp. 303 (S.D. Tex. 1986); *Levine v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 639 F. Supp. 1391 (S.D.N.Y. 1986); *Leone v. Advest, Inc.*, 624 F. Supp. 297 (S.D.N.Y. 1985); *Baker v. Powell*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,407 (D.N.J. Nov. 26, 1985); *Adams v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,328 (W.D. Okla. Sept. 20, 1985); *Green v. Shearson/Am. Express, Inc.*, No. 85-1368 (E.D. Pa. Sept. 10, 1985); *Scharp v. Cratin*, No. 85-631-Civ (S.D. Fla. Aug. 16, 1985); *Rojas Cancanon v. Smith Barney, Harris Upham & Co.*, 612 F. Supp. 996 (S.D. Fla. 1985); *Gibson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 84 C 7542 (N.D. Ill. June 18, 1985); *Dini v. Dean Witter Reynolds, Inc.*, No. CA 84-4138-T (D. Mass. May 22, 1985); *Weizman v. Adornato*, 625 F. Supp. 1101 (E.D.N.Y. 1985); *Webb v. R. Rowland & Co.*, 613 F. Supp. 1123 (E.D. Mo. 1985).

acknowledged, the issue of the arbitrability of 1934 Act claims was not before the Court and that the Court had declined explicitly to rule whether *Wilko's* bar to arbitration of Securities Act claims applied to Exchange Act claims.⁶⁸ In addition, these courts emphasized that Justice White's opinion, which so sharply questioned the extension of *Wilko* to prevent arbitration of 1934 Act claims, was only a concurrence. These district courts therefore elected not to break with the long line of pre-*Byrd* circuit court cases that had refused to order arbitration of Exchange Act claims.⁶⁹

THE CIRCUIT COURTS DIVIDE

One year after the Supreme Court decided *Byrd*, a case involving the enforceability of arbitration agreements in 1934 Act implied rights of action claims reached the circuit court level. In *McMahon v. Shearson/American Express, Inc.*,⁷⁰ the United States Court of Appeals for the Second Circuit held that plaintiffs pursuing 10(b) and 10b-5 claims are not required to submit to arbitration. Within six months, courts in the Third, Fifth, Ninth, and Eleventh Circuits adopted similar positions.⁷¹ The United States Courts of Appeals for the First and Eighth Circuits dissented, however, holding that courts should enforce agreements to arbitrate Exchange Act claims.⁷² This weight of authority against arbitration has reversed the trend among the district courts to enforce arbitration agreements.

The five circuit courts that refused to enforce arbitration agreements shared a belief that the Supreme Court's suggestion in *Byrd*

68. See, e.g., *Leone v. Advest, Inc.*, 624 F. Supp. 297, 302 (S.D.N.Y. 1985); *Adams v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,328, at 92,174 (W.D. Okla. Sept. 20, 1985).

69. E.g., *Leone*, 624 F. Supp. at 302; *Baker v. Powell*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,407, at 92,504-05 (D.N.J. Nov. 26, 1985); *Adams*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,238, at 92,174.

70. 788 F.2d 94 (2d Cir.), cert. granted, 107 S. Ct. 60 (1986).

71. *Jacobson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 797 F.2d 1197 (3d Cir. 1986); *King v. Drexel Burnham Lambert, Inc.*, 796 F.2d 59 (5th Cir. 1986), petition for cert. filed, 55 U.S.L.W. 3152 (U.S. Aug. 25, 1986) (No. 86-282); *Conover v. Dean Witter Reynolds, Inc.*, 794 F.2d 520 (9th Cir. 1986); *Miller v. Drexel Burnham Lambert, Inc.*, 791 F.2d 850 (11th Cir. 1986).

72. *Page v. Moseley, Hallgarten, Estabrook & Weeden, Inc.*, 806 F.2d 291 (1st Cir. 1986); *Phillips v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 795 F.2d 1393 (8th Cir. 1986).

that 1934 Act claims might be arbitrable did not prevent the continued application of established circuit court precedent against enforcement of arbitration agreements. The courts acknowledged that Justice White had cast some doubt on the judicial refusal to enforce arbitration of 10(b) and 10b-5 claims, but in an opinion which was after all only a concurrence.⁷³ Furthermore, these courts stressed that clear circuit court precedent controlled over Supreme Court dicta that indicated a possible preference to the contrary.⁷⁴ The controlling cases in these five circuits, as well as in virtually every other circuit, held that courts should not enforce arbitration of 10(b) and 10b-5 claims.⁷⁵ As Judge Timbers wrote in *McMahon*, the courts refused to "speculat[e] as to what the Supreme Court may do with our settled law."⁷⁶

In the most fully reasoned of the five opinions, *Conover v. Dean Witter Reynolds, Inc.*,⁷⁷ the United States Court of Appeals for the Ninth Circuit turned to the legislative history of the 1933 and 1934 Acts to counter the implication in *Byrd* that 10(b) and 10b-5 claims should be arbitrated. Justice White had contended that the *Wilko* bar to arbitration of 1933 Act claims could not be "mechanically transplanted" to 1934 Act claims because the latter Act did not create an express private right of action.⁷⁸ The court in *Conover*, however, found that an express right of action was not necessary. Judge Schroeder determined that the judicially established right to pursue damage claims for 10(b) and 10b-5 violations in federal court was so thoroughly accepted that it could not be waived.⁷⁹ Judge Schroeder observed that both Congress and the SEC had recognized that an agreement to arbitrate should not deny the investor's right to litigate 1934 Act claims.⁸⁰

73. *E.g.*, *McMahon*, 788 F.2d at 97.

74. *E.g.*, *Miller*, 791 F.2d at 854; *King*, 796 F.2d at 60.

75. *See supra* note 32 and accompanying text.

76. *McMahon*, 788 F.2d at 97.

77. 794 F.2d 520 (9th Cir. 1986).

78. *See supra* text accompanying notes 55-62.

79. 794 F.2d at 524.

80. *Id.*; *see also* Exchange Act Release No. 15,984, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,122 (July 2, 1979); *supra* note 35 and accompanying text.

The SEC reversed its position recently in an amicus brief filed in the *McMahon* case before the Supreme Court. The SEC now maintains that predispute arbitration agreements are enforceable, reasoning that the Commission's extensive power to regulate the arbitration

The court in *Conover* found additional support in recent Supreme Court decisions. The Supreme Court had stated previously that the 1933 and 1934 Acts "constitute interrelated components of the federal regulatory scheme governing transactions in securities,"⁸¹ and should be given "'a cumulative construction' which 'furthers their broad remedial purpose.'"⁸² In *Ernst & Ernst v. Hochfelder*,⁸³ the Court concluded that "the existence of a private cause of action for violations of the statute [10(b)] and the Rule [10b-5] is now well established."⁸⁴

The Ninth Circuit found other reasons not to enforce arbitration of Exchange Act claims as well. The court cited *Wilko* for the proposition that securities disputes are more properly treated in a trial than in arbitration.⁸⁵ A court proceeding provides procedural safeguards unavailable in arbitration, arbitrators are not trained in the law, and arbitrators need not keep a complete record of their proceedings.⁸⁶ The court also noted that the Arbitration Act does not authorize enforcement of all types of arbitration agreements; Congress may identify certain classes of disputes as inarbitrable.⁸⁷ The court in *Conover* held that the congressional policy of investor protection underlying both the 1933 and 1934 Acts implies a private cause of action under the 1934 Act, and empowers investors to

procedures of the stock exchanges and other self-regulatory organizations enables it to protect investors' 1933 and 1934 Act rights. Brief for the Securities & Exchange Comm'n as Amicus Curiae Supporting Petitioners at 14-18, *Shearson/Am. Express, Inc. v. McMahon* (U.S. 1986) (No. 86-44) (oral argument Mar. 3, 1987).

81. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206 (1976).

82. *Conover*, 794 F.2d at 525 (quoting *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386 (1983)).

83. 425 U.S. 185 (1976).

84. *Id.* at 196.

85. 794 F.2d at 526 (citing *Wilko v. Swan*, 346 U.S. 427, 435-36 (1953)).

86. See *infra* notes 116-119 and accompanying text.

87. The court in *Conover* stated:

Just as it is the congressional policy manifested in the federal Arbitration Act that requires courts liberally to construe the scope of arbitration agreements covered by the [sic] Act, it is the congressional intention expressed in some other statute on which the courts must rely to identify any category of claims as to which agreements to arbitrate will be held unenforceable.

794 F.2d at 522 (quoting *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 105 S. Ct. 3346, 3355 (1985)).

resolve 10(b) and 10b-5 claims in federal court rather than through arbitration.⁸⁸

The United States Courts of Appeals for the First and Eighth Circuits refused to follow this reasoning. Judge Bright, writing for the Eighth Circuit in *Phillips v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,⁸⁹ found Justice White's concurrence in *Byrd* persuasive. Acknowledging that he was at odds with other circuit courts, Judge Bright held that differences between the provisions of the 1933 and 1934 Acts, coupled with a strong federal policy favoring arbitration, prevent courts from extending the *Wilko* bar to Exchange Act claims.⁹⁰ Courts therefore should enforce agreements to arbitrate 10(b) and 10b-5 claims.

The inconsistent but vigorous response of the district and circuit courts to *Byrd* demonstrates that the enforceability of arbitration agreements in Exchange Act claims is no longer settled. Many of the courts seized on the Court's dicta to enforce arbitration agreements, while others rejected this new direction. These sharply divergent interpretations of *Byrd* reflect a dispute over the relative importance of underlying policy goals. The Court has revived a deep-seated conflict between investor protection from securities fraud and efficient dispute resolution through arbitration.

ANALYSIS OF THE COMPETING POLICIES: EFFICIENCY V. INVESTOR PROTECTION

Efficiency

Courts and commentators agree that arbitration saves time and money over litigation and therefore provides a more efficient means of dispute resolution.⁹¹ This efficiency has become increasingly important in the securities industry because public investment has grown rapidly in recent years. The number of investor-

88. 794 F.2d at 525.

89. 795 F.2d 1393 (8th Cir. 1986).

90. The court stated: "We hold, then, that Congress has not evinced an intention to preclude the waiver of judicial remedies for the section 10(b) and Rule 10b-5 rights at issue here." *Id.* at 1398.

91. See, e.g., *Wilko v. Swan*, 346 U.S. 427, 438 (1953). One commentator, discussing the importance of speedy dispute resolution, asserts that "[d]elay can be tantamount to a denial of due process." Krause, *supra* note 29, at 720-21.

broker disputes has grown proportionately,⁹² and investors and brokers increasingly have employed arbitration to settle their disputes rather than undertake the expense and delay of a trial.⁹³

The well-established application of the *Wilko* doctrine to Exchange Act claims, which renders them inarbitrable, raises the potential for inefficiency when litigants combine those federal claims with state-law claims. Such "mixed claims" occur when a federal court acquires pendent jurisdiction over state-law claims arising from the same transaction that produced federal securities law claims. Mixed state and federal claims are common because plaintiff investors often add 10(b) and 10b-5 counts to their common-law fraud or breach of contract claims in order to get into federal court. In addition, some plaintiffs attempt to avoid arbitration by asserting inarbitrable federal claims.⁹⁴

Prior to *Byrd*, courts resolved such mixed claims in one of two ways. In one approach, courts severed the state claims from the federal claims and either ordered arbitration of those state claims according to the terms of the parties' agreement, or stayed arbitration until after litigation of the federal claims.⁹⁵ The federal claims were tried separately. In a second approach, known as the "intertwining" doctrine, courts tried both state and federal claims together if the claims were so intertwined that separation was impractical.⁹⁶ By considering the claims together, courts were able to provide a reasonably efficient method of resolving the entire dispute.

92. Investors filed 3,000 securities claims in federal district courts between Mar. 31, 1983, and Mar. 31, 1984. Katsoris, *supra* note 2, at 279 n.5 (citing STATISTICAL ANALYSIS AND REPORTS DIVISION, ADMINISTRATIVE OFFICE OF UNITED STATES COURTS, FEDERAL JUDICIAL WORKLOAD STATISTICS A-9 (1984)).

93. In 1980, 830 investors and brokers initiated arbitration proceedings; in 1983, the number increased to 1,731. *Id.* at 279-80 n.7; *see also* D. Lipton, Arbitration in the Securities Industry: Too Much of a Good Thing? 3 (unpublished study on file with the National Institute for Dispute Resolution, Washington, D.C.).

94. Katsoris, *supra* note 2, at 305 & n.202.

95. *Id.* at 302-03; Peloso, *supra* note 44, at 948-50. *See generally* Note, *Mixed Arbitrable and Nonarbitrable Claims in Securities Litigation: Dean Witter Reynolds, Inc., v. Byrd*, 34 CATH. U. L. REV. 525 (1985); Note, *Dean Witter Reynolds Inc., v. Byrd: The Unraveling of the Intertwining Doctrine*, 62 DEN. U. L. REV. 789 (1985).

96. Katsoris, *supra* note 2, at 303-04 (citing *Sibley v. Tandy Corp.*, 543 F.2d 540, 544 (5th Cir. 1976), *cert. denied*, 434 U.S. 824 (1977)); Peloso, *supra* note 44, at 948-49.

The Supreme Court in *Byrd* rejected the intertwining doctrine and followed the first approach, holding that state-law claims must be severed from federal claims and then arbitrated.⁹⁷ In so doing the Court increased the inefficiency of resolving disputes involving inarbitrable Exchange Act claims. Courts frequently have trouble distinguishing state law claims from federal securities law claims when both arise from a single securities transaction.⁹⁸ As a result, courts waste time determining which claims to sever for arbitration and which to retain for trial. The *Byrd* holding forces lower courts to continue this awkward procedure, and prevents them from simply hearing all claims when the allegations are indistinguishable.

Byrd also creates the potential for duplication of effort in resolving securities disputes. When a court severs similar state and federal claims, the state arbitration proceeding and the federal trial cover similar ground, determining similar questions of fact. Under *Byrd*, a court cannot stay arbitration of state claims until litigation of federal claims is complete.⁹⁹ Such parallel proceedings defeat the federal policy of pendent jurisdiction, which promotes judicial economy by resolving related state and federal issues in a single forum.¹⁰⁰ Not only does the holding in *Byrd* increase inefficiency, it may allow other inequitable results as well.¹⁰¹

97. 470 U.S. at 218.

98. Katsoris, *supra* note 2, at 298, 303; Krause, *supra* note 29, at 717.

99. 470 U.S. at 223.

100. Katsoris, *supra* note 2, at 305 n.201; Krause, *supra* note 29, at 717.

101. Because federal courts and arbitrators follow different rules of procedure, evidence, and law, separate proceedings may produce conflicting conclusions even though both actions arose out of the same securities transaction. See *infra* notes 116-19 and accompanying text.

Mandatory severance and arbitration of pendent state claims also raises the possibility that state arbitration findings of fact will have collateral estoppel effect on simultaneous or subsequent litigation of federal claims. Currently, the res judicata or collateral estoppel effect of arbitration on federal securities claims is unclear because the Supreme Court has not ruled on the issue. In *Greenblatt v. Drexel Burnham, Lambert, Inc.*, 763 F.2d 1352 (11th Cir. 1985), the court held that in principle an arbitration decision could have preclusive effect on subsequent securities litigation in federal court. *Id.* at 1360. The court in *Greenblatt* noted, however, that in *McDonald v. City of West Branch*, 466 U.S. 284 (1984), the Supreme Court stated that an arbitrator's decision cannot have res judicata or collateral estoppel effect on a civil rights action later brought under 42 U.S.C. § 1983 in federal court. *Greenblatt*, 763 F.2d at 1360.

In *Byrd*, the Court was skeptical that a federal court would grant res judicata or collateral estoppel effect to prior arbitral findings in a securities dispute. The Court said that it is "far from certain that arbitration proceedings will have any preclusive effect on the litigation of

Many district courts, recognizing the inefficiency inherent in the *Byrd* severance approach but unable to apply the intertwining doctrine, attempted to resolve the inefficiency by enforcing arbitration of all claims, state and federal.¹⁰² Enforcing arbitration agreements with respect to both state and federal claims allows these courts to sidestep the difficulties of resolving essentially identical claims in separate proceedings, and so promotes quicker and less expensive settlement of investor-broker disputes. These district courts found support for this approach in the dicta of the majority opinion in *Byrd*, and in Justice White's concurring opinion.¹⁰³ Many of these district cases, however, have been reversed by the circuit courts,¹⁰⁴ and the severance approach continues to be the prevailing approach, despite its inefficiency.

From the standpoint of pure efficiency, arbitration of both federal and state claims in a single proceeding is the preferred method of dispute resolution.¹⁰⁵ Because continued application of the *Wilko* doctrine to Securities Exchange Act of 1934 claims precludes the arbitration of those claims, adjudication of both state and federal claims in a single judicial forum is the next most efficient method of dispute resolution. The Supreme Court's decision in *Byrd* to compel arbitration of the state claims, however, invali-

nonarbitrable federal claims." 470 U.S. at 222. The court in *Greenblatt* concluded that the Supreme Court seems to favor a case-by-case approach that would determine the res judicata or collateral estoppel effect of arbitration on a federal court proceeding by "focusing on the federal interests in insuring a federal court determination of the federal claim, the expertise of the arbitrator and his scope of authority under the arbitration agreement, and the procedural adequacy of the arbitration proceeding." 763 F.2d at 1361; see Katsoris, *The Securities Arbitrators' Nightmare*, 14 FORDHAM URB. L. J. 3, 9-11 (1986). Professor Katsoris maintains that "[i]t is somewhat doubtful that a prior arbitration award would have a preclusive effect upon subsequent litigation of a federal securities claim." *Id.* at 9.

102. See *supra* note 63.

103. See *supra* notes 64-66 and accompanying text.

104. See *supra* notes 70-88 and accompanying text.

105. Arbitration of both federal and state claims does not lead necessarily to true economic efficiency. Assuming that streamlined arbitration proceedings are less likely to reach the "correct" result, then the time and money saved through arbitration do not come without further costs. An investor discouraged by the results of arbitration of a securities fraud claim will limit future brokerage investment, limiting the pool of available risk capital. Furthermore, brokers avoiding liability through arbitration after actually violating securities laws will be more likely to test the limits of securities law enforcement in the future. Considering the arguable arbitration bias in light of the above, see *infra* text accompanying notes 120-24, economic efficiency through arbitration is uncertain.

dates that approach, and leaves litigants to face the least efficient scenario: dual proceedings. Whether this inefficiency and inconvenience is justified depends on the relative strength of another compelling federal interest, the protection of investors.

Investor Protection

Despite the important Arbitration Act policy to promote efficient dispute resolution, the investor protection policy of the Exchange Act dictates that courts should not enforce arbitration agreements with respect to Exchange Act claims. The Supreme Court has recognized that the Arbitration Act policy may be limited by "sufficiently compelling" contrary federal interests.¹⁰⁶ In *Wilko* the Court decided that the need to protect investors from securities issuers' fraudulent conduct justified an exception to the Arbitration Act.¹⁰⁷ The Court therefore barred enforcement of arbitration agreements as to claims brought under the Securities Act. The shared purpose of the Exchange Act and the Securities Act implies that Exchange Act claims likewise should be excepted from coverage by the Arbitration Act's national policy favoring arbitration.

Several features of arbitration agreements compromising investors' interests also point toward resolving the policy conflict in favor of the Exchange Act's purpose of investor protection. First, investors rarely can bargain fairly for such an agreement. The typical individual investor is in a weak bargaining position relative to the broker with whom he or she deals. As the Court in *Wilko* observed, investors usually know much less about the securities market and securities trading than brokers.¹⁰⁸ Investors expect, and pay for, knowledgeable brokers; the disproportionality in knowledge of securities trading, however, can disadvantage the investor when the parties agree to the terms of their relationship.

A potential securities purchaser often does not understand fully the risks involved in various types of investments; and the investor is even less likely to know what constitutes unacceptable broker conduct. The investor therefore has no clear idea of the probability

106. See, e.g., *Byrd*, 470 U.S. at 219.

107. 346 U.S. at 438.

108. *Id.* at 435.

or nature of a dispute arising with the broker. As a result, the investor is unable to assess properly the relative advantages of arbitration as opposed to litigation and make an informed decision whether to sign an arbitration agreement.¹⁰⁹

Second, investors suffer because often they do not read or understand the contracts they sign with brokers.¹¹⁰ The brokerage agreement is usually a standard form in fine print with technical language. The agreement may not feature prominently the arbitration provision in which the investor consents to submit all disputes with the broker to arbitration, and brokers may not take time to identify or explain it.¹¹¹ Furthermore, although these agreements probably constitute contracts of adhesion,¹¹² which are generally unenforceable,¹¹³ courts have nevertheless upheld them.¹¹⁴ Perhaps recognizing the inequity of these provisions, the SEC recently has

109. *See id.* at 435; *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831, 835 (7th Cir. 1977) ("Lacking bargaining power and extensive information about his investment, this type of individual is most vulnerable to securities swindles and in most need of the special protections and remedies afforded by the Securities laws.").

110. *Stansbury & Klein*, *supra* note 35, at 37.

111. *Id.* In response to this problem, the SEC urges brokers to advise prospective customers of their 1933 and 1934 Act rights before they sign an arbitration agreement. *See Notice to Broker-Dealers Concerning Clauses in Customer Agreements Which Provide for Arbitration of Future Disputes*, Exchange Act Release No. 15,984, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,122 at 81,976-78 (July 2, 1979). Similarly, the Securities Industry Conference on Arbitration advises investors that arbitration agreements may not be enforceable under federal securities laws. SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, *ARBITRATION PROCEDURES* frontispiece (1984) [hereinafter *SICA HANDBOOK*].

112. *See J. CALAMARI & J. PERILLO*, *THE LAW OF CONTRACTS* § 1-3, at 6 (2d ed. 1977); *see also Katsoris*, *supra* note 101, at 11-14.

113. Courts generally will not enforce a contract of adhesion if: (1) the contract or a term is not within the reasonable expectation of the weaker party; and/or (2) the contract or term is unduly oppressive, unconscionable or against public policy. *Katsoris*, *supra* note 2, at 306-07 (citing *Graham v. Scissor-Tail, Inc.*, 28 Cal. 3d 807, 820, 623 P.2d 165, 172-73, 171 Cal. Rptr. 604, 612 (1981)); *see Finkle & Ross v. A.G. Becker Paribas, Inc.*, 622 F. Supp. 1505 (S.D.N.Y. 1985); *J. CALAMARI & J. PERILLO*, *supra* note 112, at § 9-44.

114. Three post-*Byrd* district court decisions have held that arbitration agreements are enforceable despite their nature as contracts of adhesion, because the agreements were not unconscionable or against public policy. *Brener v. Becker Paribas, Inc.*, 628 F. Supp. 442 (S.D.N.Y. 1985); *Ilan v. Shearson/Am. Express, Inc.*, 632 F. Supp. 886 (S.D.N.Y. 1985); *Finkle & Ross v. A.G. Becker Paribas, Inc.*, 622 F. Supp. 1505 (S.D.N.Y. 1985); *see also Surman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 733 F.2d 59, 61 n.2 (8th Cir. 1984) ("There is certainly nothing inherently unfair about . . . arbitration clauses, and they are therefore valid and enforceable.").

attempted to prohibit the inclusion of such provisions in brokerage contracts.¹¹⁵

Finally, the arbitration process itself potentially undercuts the interests of investors. Arbitration proceedings, for example, do not include the procedural safeguards of a trial. Arbitrators are not bound strictly by judicial precedent, nor must they follow formal rules of evidence or allow pretrial discovery.¹¹⁶ In addition, the award of an arbitrator is subject only to very limited judicial review.¹¹⁷ Review is difficult because the hearings usually do not generate a complete record,¹¹⁸ and arbitrators are not required to give reasons for their awards.¹¹⁹ Investors who submit to arbitration may find fewer avenues of appeal to vindicate Exchange Act rights than if they had sued in federal court.

Arbitration also may be biased against investors because the several self-regulatory organizations¹²⁰ administer the arbitration process. The SROs operate under the Uniform Code of Arbitration promulgated by the Securities Industry Conference of Arbitra-

115. SEC Rule 15c2-2 states in part: "It shall be a fraudulent, manipulative or deceptive act or practice for a broker or dealer to enter into an agreement with any public customer which purports to bind the customer to the arbitration of future disputes between them arising under the Federal Securities laws" 17 C.F.R. § 240.15c2-2 (1986).

116. *Alexander v. Gardner-Denver Co.*, 415 U.S. 36, 57-58 (1974) ("[T]he usual rules of evidence do not apply [in arbitration]; and rights and procedures common to civil trials, such as discovery, compulsory process, cross-examination, and testimony under oath, are often severely limited or unavailable."). See generally SICA HANDBOOK, *supra* note 111, (explanation of arbitration procedures).

117. The Arbitration Act provides the following grounds for district courts to vacate an award:

- (a) Where the award was procured by corruption, fraud, or undue means.
- (b) Where there was evident partiality or corruption in the arbitrators, or either of them.
- (c) Where the arbitrators were guilty of misconduct in refusing to postpone the hearing . . . or in refusing to hear evidence pertinent and material to the controversy
- (d) Where the arbitrators exceeded their powers

9 U.S.C. § 10 (1982).

118. See *Alexander*, 415 U.S. at 57-58; *Wilko v. Swan*, 346 U.S. 427, 436 (1953). Parties may request that a record be made at their own expense. SICA HANDBOOK, *supra* note 111, at 8.

119. SICA HANDBOOK, *supra* note 111, at 8.

120. Four types of SROs exist: (1) the national securities exchanges, such as the New York Stock Exchange and the Chicago Board Options Exchange; (2) the National Association of Securities Dealers; (3) the Municipal Securities Rulemaking Board; and (4) the Registered Clearing Agencies. L. Loss, *supra* note 23, at 689-98.

tion.¹²¹ When an investor makes a complaint, the SRO of which the broker is a member selects an arbitrator or panel of arbitrators from a list maintained by the SRO. The Uniform Code of Arbitration requires that arbitrators not be employees of the SRO, although they may work elsewhere in the securities industry.¹²² Although the Code also prescribes that a majority of the members of a panel be persons not employed in any capacity in the industry,¹²³ even the "public" arbitrators usually have or have had some association with the securities industry because of the expertise required to resolve investor-broker disputes. Commentators have argued, therefore, that arbitration panels are inclined to sympathize more with a broker than an investor.¹²⁴

Arbitration agreements, then, tend to undermine investors' Exchange Act rights against brokers. Such agreements often are not bargained for fairly, because of the investors' weak bargaining position, and they frequently compel investors to agree to arbitration whether they choose to or not. Finally, the arbitration process itself arguably is biased against investors. In terms of investor protection, these flaws constitute a "compelling interest" sufficient to outweigh the Arbitration Act policy of efficient dispute resolution and suggest that Exchange Act claims should not be subject to arbitration agreements.

RECOMMENDATIONS

Application of the *Wilko* doctrine to Exchange Act claims presents a conflict between efficient resolution of disputes and protection of investors. Courts should resolve this conflict in favor of investor protection by denying enforcement of arbitration agreements in Exchange Act claims. Congress's policy of investor protection, embodied in the 1933 and 1934 Acts, is a sufficiently com-

121. SICA HANDBOOK, *supra* note 111, at 1.

122. *Id.* at 3; *see Katsoris, supra* note 2, at 310.

123. SICA HANDBOOK, *supra* note 111, at 3.

124. Katsoris, *supra* note 2, at 308-09; Krause, *supra* note 29, at 718; *see also* Hope v. Superior Court, 122 Cal. App. 3d 147, 154, 175 Cal. Rptr. 851, 856 (1981), *cert. denied*, 456 U.S. 910 (1982) (the "structure of the governance of the [New York Stock Exchange] is such that there exists a presumptive institutional bias in favor of member firms."). *See generally* Parr v. Superior Court, 139 Cal. App. 3d 440, 446, 188 Cal. Rptr. 801, 805 (1983) (presumption of a securities exchange's institutional bias was rebuttable).

elling federal interest to except Exchange Act claims from the strong national policy favoring efficiency through arbitration. Although arbitration agreements may save time and money, they achieve this efficiency at too high a cost. Such agreements effectively compel securities purchasers to give up the right to sue in federal court for the less certain protections of arbitration. Many courts have favored efficiency over investor protection, and thus have enforced arbitration agreements in 1934 Act claims, by relying on the policy of efficiency set forth by the Arbitration Act. As the Court emphasized in *Byrd*, however, efficiency is not the overriding purpose of the Arbitration Act.

Nor is the argument for enforcement based on differences between the language of the 1933 and 1934 Acts persuasive. Section 10(b) of the 1934 Exchange Act lacks the provision creating a special right of action for investors which section 12(2) of the 1933 Securities Act contains. By strict analogy, therefore, the *Wilko* reasoning barring arbitration of 1933 Act claims does not extend to implied rights of action under the 1934 Act. The issue of whether to enforce arbitration agreements, however, is fundamentally one of policy rather than statutory construction. The extent to which arbitration agreements damage investors' rights indicates forcefully that enforcement is not consistent with Congress's intention to protect investors through the Exchange Act. Until the Supreme Court decides otherwise, federal courts should continue to guarantee investors the right to litigate 10(b) and 10b-5 claims, even though they have signed an arbitration agreement.

A total ban on arbitrating investor-broker disputes, however, is not desirable. Congress and the securities industry can take steps to improve the resolution of investor-broker disputes by providing for arbitration in limited situations. For its part, Congress should amend the Exchange Act to create an express, but qualified, right of action for investors. Generally, courts should not deny investors this right, despite the presence of an arbitration agreement in the brokerage contract. Congress should allow courts to enforce these agreements, however, under three conditions. First, the agreement must be optional; an agreement to arbitrate future disputes must not have been a precondition to opening an account. Second, the broker must have advised the prospective investor clearly that he or she would lose the right to sue in federal court by signing the

agreement. Third, the amount in dispute must be less than a specified dollar figure.¹²⁵

The first two requirements would reduce the likelihood that arbitration agreements would constitute contracts of adhesion, and would promote the fair dealing between brokers and investors which both commentators and the SEC have urged.¹²⁶ The amount in controversy requirement would distinguish smaller, less complex disputes for which arbitration is suitable from larger, more complicated controversies which call for the procedural advantages of a trial.

Together, these restrictions would permit investors and brokers to enjoy the economies of arbitration when the risks of compromising an investor's rights are low. Arbitration makes sense for relatively simple disputes, so long as the investor entered an arbitration agreement freely and with full knowledge of the consequences. In many instances, investors with smaller claims will prefer a speedy resolution through arbitration. Investors with larger disputes, on the other hand, should be guaranteed the right to sue under the Exchange Act. They are more likely to desire, and to be able to afford, a trial, and their claims deserve the more careful fact finding and application of procedural safeguards available in federal court.¹²⁷

As a related improvement, the self-regulatory organizations should discontinue their control of the arbitration process.¹²⁸ Ideally, an independent forum should handle such disputes, perhaps under the direction of the American Arbitration Association. This step would remove the risk and appearance of conflicts of interest

125. The requisite amount might be set at, for example, \$50,000. The amount should be at least as high as the cost of litigating a fairly simple claim.

126. See *Recent Developments—Federal and State Securities Claims: Litigation or Arbitration?*, 61 WASH. L. REV. 245, 257-58 (1986). SEC Release No. 15,984 states that "[r]equiring the signing of an arbitration agreement without adequate disclosure as to its meaning and effect violates standards of fair dealing with customers and constitutes conduct that is inconsistent with just and equitable principles of trade." Notice to Broker-Dealers Concerning Clauses in Customer Agreements Which Provide for Arbitration of Future Disputes, Exchange Act Release No. 15,984, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,122, at 81,978 (July 2, 1979) (footnotes omitted).

127. Investors with claims greater than the threshold amount could still request arbitration; they simply could not be forced into arbitration because they signed arbitration agreements when they first entered into the brokerage contract. See *supra* note 44.

128. See Katsoris, *supra* note 101, at 14; *Recent Developments*, *supra* note 126, at 260.

that exist under the present system, in which a broker's dispute is arbitrated by other securities professionals. As it does now, the SEC must continue to review whatever procedures are established to arbitrate securities disputes. Commentators suggest also that securities arbitration should employ more arbitrators who are wholly unconnected with the industry.¹²⁹ Insofar as the complexity of a dispute allows, the "public" arbitrators on a panel should be truly public. They should not be present or past securities professionals. As an alternative, those who administer arbitration might select arbitrators from lists maintained by the American Arbitration Association.

CONCLUSION

The decision in *Byrd* has caused great confusion. Lower federal courts clearly are divided over whether to enforce agreements to arbitrate with respect to investor claims brought under the Securities Exchange Act of 1934. Dicta and Justice White's concurrence in *Byrd* convinced many district courts to enforce arbitration agreements despite many years of circuit court precedent to the contrary. Five of the seven courts of appeals addressing the issue have denied enforcement, however, apparently not persuaded that the Supreme Court has in fact disclosed a preference for arbitration. As a result, neither brokers nor investors know whether they will be bound by the arbitration agreements they sign.

Congress should make its intentions clear by amending the Exchange Act. The arbitrability of section 10(b) and rule 10b-5 claims ultimately is a legislative decision. Congress should not rely entirely on the self-regulatory organizations or the SEC to protect investors' rights. Congress must balance the Arbitration Act's policy of efficient dispute resolution against the Exchange Act's purpose of investor protection. One proposal is to establish an amount in controversy standard that permits arbitration of smaller, fairly straightforward disputes, but prohibits enforcement of arbitration agreements against larger, more complex claims. The securities industry, in turn, must work toward making the arbitration process as impartial as possible. The goal of these or similar reforms

129. Katsoris, *supra* note 2, at 311-12; Peloso, *supra* note 44, at 950.

should be, first and foremost, to protect investors in their dealings with brokers, and only then to encourage, so far as is consistent with that protection, swift and economical resolution of disputes.

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