Speech

Mandatory Arbitration: An Illusory Remedy for Public Company Shareholders

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PLI's The SEC Speaks in 2018
Washington D.C.

Feb. 24, 2018

Good morning, and welcome back to the second day of the conference. It takes real dedication to be here on a Saturday morning, so thank you for your participation. And I want to express my thanks to the Practising Law Institute for the invitation to speak to you.

As we start another day of SEC Speaks, let me begin by reminding you that the views I express, as well as the views that will be expressed by the SEC employees who follow after me, are our own views, and they do not necessarily represent the views of the Commission, the individual Commissioners, or our colleagues on the Commission staff.[1]

Today is a special day for the Office of the Investor Advocate. I started this job four years ago today, and because I am the first Investor Advocate that is also the day the Office of the Investor Advocate came into existence. During the past four years, through the efforts of the talented and dedicated individuals who have joined my Office and work so hard to advocate for investors, we have helped to elevate the Commission's thinking about the needs of today's investors. And we continue to make progress in some important areas. For example, the SEC Ombudsman, Tracey McNeil, has recently launched an electronic Ombudsman Matter Management System (OMMS) to make it easier for investors to let us know of any concerns about the SEC or a self-regulatory organization. An electronic OMMS form is available at the Ombudsman's website, www.sec.gov/ombudsman, and we encourage investors to check it out.

This morning, I would like to share some of my views on the issue of mandatory arbitration and, more specifically, on efforts to force public company shareholders to forego class action lawsuits and seek recovery individually through arbitration. This has been a matter of concern to investors recently,[2] after commentators have suggested that U.S. IPO issuers should consider including arbitration provisions in their articles or bylaws.[3]

The idea of forced arbitration has been promoted as a way to reduce costs of securities litigation for public companies and thereby remove a perceived disincentive for companies to be public. Reportedly, it is too easy for plaintiffs' firms to bring dubious cases and win settlements,[4] and some have argued that class action lawsuits, even meritorious ones, fail to compensate harmed investors in any meaningful way.[5]

There may be some validity to these concerns. But stripping away the right of shareholders to bring a class action lawsuit seems to me draconian and, with respect to promoting capital formation, counterproductive. Let me explain why.

If we take a step back and look at the big picture, there are some very good reasons why shareholders have been given private causes of action. In the United States, the government has traditionally played a limited role in policing our markets, as evidenced by the fact that only 4,600 SEC employees oversee approximately $72 trillion in securities trading each year, as well as the disclosures of more than 8,100 public companies and the activities of more than 26,000 registered entities.[6] Because of the limited scope of the SEC's resources, investors themselves have typically borne a large share of the

responsibility for policing the markets and rooting out misconduct. Over the years, Congress,[7] the Supreme Court,[8] and former SEC Commissioners[9] have recognized the importance of private suits in helping to protect investors and deter wrongdoing.

The SEC, itself, continually reminds investors of its constraints in advocating for their individual interests. Consider how many times every day an investor is told by the SEC staff that we cannot give them legal advice or represent their individual interests. For good reasons, nearly every SEC Investor Alert and hotline phone call includes a disclaimer to the effect that the reader or caller should consult with an attorney who specializes in securities law.[10] In fact, I have personally communicated this to investors many times over the course of my career. When I was a state regulator, I frequently cautioned investors that they should retain private counsel, because even though the interests of victims were generally aligned with the interests of the State of Kansas, those interests could diverge—for example, it might be in the best interest of the state to take away a license, which may decrease the likelihood that a victim would be repaid.

In addition, investors have remedies that may not be available to regulators, the most important of which is the ability to seek full restitution of their losses instead of merely disgorging the bad actor's ill-gotten gains. Resource constraints can also make regulators pick and choose among cases, which means that the government may decline to pursue many viable cases. In short, our regulatory framework assumes that investors themselves will serve an important role in policing the markets.

Advocates for mandatory arbitration suggest that arbitration provides a sufficient way for investors to seek redress, even if investors are denied the right to pursue class action lawsuits. But, as a practical matter, unless a class-wide remedy is available there is often no other recourse for investors with small holdings.[11] Cases involving accounting irregularities or other corporate misdeeds are usually far more complex than the typical dispute involving a consumer contract, or even a dispute against a broker or investment adviser that involves the investor's personal account. For individual investors who suffer losses in a widespread fraud, the costs of bringing claims individually in arbitration may well exceed the amount of the likely recovery. And, unless their losses are sizable, victims will struggle to find attorneys to represent them, much less experts to establish elements such as materiality, reliance, loss causation, and damages. This can lead to a collective action problem, where each investor lacks the economic incentive to bring an individual case, even though the collective losses of multiple investors would justify the costs of the litigation.[12]

Some have observed that class actions generally result in "institutional shareholders effectively suing themselves," paying high costs for the defense while giving plaintiffs' attorneys a large share of any settlement.[13] But institutional investors, who presumably have the economic incentives and resources to pursue individual arbitration, have been vocal in their opposition to forced arbitration. In a recent letter to the SEC, the Council of Institutional Investors expressed its view that these clauses represent a potential threat to principles of sound corporate governance that balance the rights of shareholders against the responsibility of corporate managers to run the business.[14] In my view, there is considerable value in seeing companies held accountable for wrongdoing, even if the compensatory mechanism is imperfect.

There are other downsides to relying upon individual arbitration as the sole means of recourse. For example, disputes that go to arbitration rather than the court system generally do not become part of the public record, which diminishes their deterrent effect.[15] And, while arbitration is often touted as an efficient means for resolving disputes, it seems terribly inefficient to require multiple plaintiffs to prove up the same claims in separate proceedings.[16] Arbitration also lacks procedural rules that require written opinions or decisions explaining the reasoning for an award, and the grounds for appeal tend to be extremely narrow.[17] As a result, the evolution of case law can be hindered.

Consider, for a moment, how different the federal securities laws would be in the absence of civil litigation. How would we define an investment contract in various fact-specific contexts without the cases that have become our guideposts? Would investors even be able to pursue claims under Rule 10b-5?

As a legal matter, I believe the Commission has been on solid footing when objecting to companies forcing shareholders into arbitration. Securities Act Section 8(a) allows the Commission to refuse to accelerate the effective date of an issuer's registration statement upon considering, among other things, the facility with which the rights of the issuer's securities holders can be understood, the public interest, and the protection of investors. If an issuer chooses to file a registration statement with a forced arbitration provision, I would urge the Commission and staff to make use of Section 8(a).

More broadly, Securities Act Section 14 and Exchange Act Section 29(a) state that any condition that would bind a person to waive compliance with those laws is void. The Supreme Court has upheld the

validity of arbitration clauses in brokerage customer agreements, but, for the reasons I've already stated, I would suggest that arbitration is not a viable option for investors—particularly small investors—in cases involving fraud on the market or other corporate misconduct. In my view, if private remedies are an important part of the enforcement mechanisms for the '33 and '34 Acts, and forced arbitration provisions would render those remedies illusory for public company shareholders, then those arbitration provisions are void because they would undermine the enforcement of substantive provisions of the Acts.

Admittedly, there are legal arguments to be made on the other side. The law in this area is messy, particularly in the context of an offering that is reviewed by the SEC, and this specific issue has not been addressed by the Court. But, before public companies push this issue and try to go down this road, it's worth considering where it may ultimately lead. For instance, if investors are blocked from seeking redress in an egregious case, it is not difficult to imagine calls for the SEC to receive greater resources and expanded enforcement powers (such as the ability to seek full restitution) to make up for the loss of private causes of action.

Or, perhaps more likely, investors may pursue other avenues to deter the use of forced arbitration. Not long ago, investors were outraged when a company went public with non-voting shares, and they turned to the index providers for a market solution that would prevent passive investors from being forced to buy the shares. If a company strips away the ability of investors to seek class actions, investors could go down that same road and ask the index providers to keep the company off the index. Before long, if the SEC fails to act, the index providers could step into that vacuum and become the de facto regulators of corporate governance in this country.

Let me close by saying that I hope the Commission does not actually have to confront this issue again in the near future. In my view, the Commission's time would be better spent on matters that address more urgent needs of issuers and their investors. Chairman Clayton, to his credit, has indicated that he is not anxious to expend Commission resources on this issue,[18] and I hope companies are not anxious to push it. For those of you who advise companies that may be curious about adopting mandatory arbitration clauses, I encourage you to talk to them about the downsides and the likely resistance they would encounter from investors and their advocates, including me.

Thank you.

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[1] The United States Securities and Exchange Commission (SEC), as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.

[2] *See* Letter from Jeffrey P. Mahoney, General Counsel, Council of Institutional Investors, to William H. Hinman, Dir., Div. of Corp. Fin., SEC (Jan. 29, 2018), http://www.cii.org/files/issues_and_advocacy/correspondence/2018/January%2029%202018%20letter%20to%20Mr_%20Hinman%20on%20forced%20arbitration%20(final).pdf .

[3] *See, e.g.,* Stephen Bainbridge, *The SEC Should Authorize Mandatory Arbitration of Shareholder Class Action Lawsuits*, (Jan. 30, 2018, 2:21 PM), http://www.professorbainbridge.com/professorbainbridgecom/2018/01/the-sec-should-authorize-mandatory-arbitration-of-shareholder-class-action-lawsuits.html .

[4] *See* Sara Randazzo, *Companies Face Record Number of Shareholder Lawsuits*, Wall St. J., (Aug. 22, 2017, 5:30 AM), https://www.wsj.com/articles/why-lawsuits-targeting-stock-drops-are-on-the-rise-1503307800 .

[5] *See* Hal S. Scott & Leslie N. Silverman, *Stockholder Adoption of Mandatory Individual Arbitration for Stockholder Disputes*, 36 Harv. J. L. & Pub. Pol'y 1187, 1194 (2013).

[6] *Examining the SEC's Agenda, Operations, and Budget: Hearing Before the H. Committee on Financial Services*, 115th Cong. (2017) (statement of Jay Clayton, Chairman, U.S. Securities and Exchange Commission), https://financialservices.house.gov/uploadedfiles/hhrg-115-ba00-wstate-jclayton-20171004.pdf.

[7] Notably, Congress affirmed the importance of preserving the federal securities class action when enacting the Private Securities Litigation Reform Act of 1995, legislation which purported to weed out frivolous suits through a variety of procedural and other measures. Joint Explanatory Statement of the Committee of Conference on H.R. 1058 at 31, *reprinted in* 2 U.S.C.A.A.N. 730 (104th Cong., 1st Sess. 1995) ("The private securities litigation system is too important to the integrity of American capital

markets to allow this system to be undermined by those who seek to line their own pockets by bringing abusive and meritless suits. Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs. This legislation seeks to return the securities litigation system to that high standard.”).

[8] Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 345 (2005) (“The securities statutes seek to maintain public confidence in the marketplace…. They do so by deterring fraud, in part, through the availability of private securities fraud actions.”); J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) (“While this language [in Exchange Act §14(a)] makes no specific reference to a private right of action, among its chief purposes is ‘the protection of investors,’ which certainly implies the availability of judicial relief where necessary to achieve that result.”); Basic, Inc. v. Levinson, 485 U.S. 224, 231 (1988) (“Judicial interpretation and application, legislative acquiescence, and the passage of time have removed any doubt that a private cause of action exists for a violation of §10(b) and Rule 10b-5, and constitutes an essential tool for enforcement of the 1934 Act’s requirements.”).

[9] *See, e.g., Securities Investor Protection Act of 1991: Hearing Before the Subcomm. on Securities of the S. Comm. on Banking, Housing and Urban Affairs*, 102d Cong. 15-16 (1991) (quoting then-Chairman Richard C. Breeden as saying “private actions…have long been recognized as a necessary supplement…and an essential tool in the enforcement of federal securities laws. Because the Commission does not have adequate resources to detect and prosecute all violations of the federal securities laws, private actions perform a critical role in preserving the integrity of our securities markets.”).

[10] *See, e.g.*, Office of Investor Education and Advocacy, Investor Alert: Credit Cards and Investments – A Risky Combination (Feb. 14, 2018), https://www.sec.gov/oiea/investor-alerts-and-bulletins/ia_riskycombination.

[11] The available evidence from other types of forced arbitration provisions bear this out. In the commercial contract context, studies show that far fewer claims are pursued when would-be plaintiffs are limited to arbitration and banned from bringing a class action. For example, a *New York Times* analysis found that in the United States between 2010 and 2014, only 505 consumers went to arbitration over a dispute of $2,500 or less. During that five-year time period, three cell phone and cable TV providers with a combined customer base of nearly 200 million people faced only 78 consumer arbitrations. The *Times* concluded that once people were blocked from going to court as a group, most dropped their claims entirely. Jessica Silver-Greenberg and Robert Gebeloff, *Arbitration Everywhere, Stacking the Deck of Justice*, N.Y. Times, Oct. 31 2015, https://www.nytimes.com/2015/11/01/business/dealbook/arbitration-everywhere-stacking-the-deck-of-justice.html .

[12] *See* Christopher R. Leslie, *The Significance of Silence: Collective Action Problems and Class Action Settlements*, 59 Fla. L. Rev. 71, 73 (2007).

[13] *See supra* note 5 at 1194.

[14] *See supra* note 2. In an amicus brief submitted by CalPERS and CalSTRS, the two California public pension funds averred that the ability of investors injured by securities fraud to recover through class actions is essential to the integrity of the securities markets and that “[e]viscerating the class action mechanism in securities cases would have disastrous consequences for the amici and their beneficiaries.” *See* Brief of the Cal. Pub. Employees’ Ret. System et al. as Amici Curiae Supporting Appellees, Conn. Ret. Plans & Tr. Funds v. Amgen Inc., 660 F.3d 1170 (9th Cir. 2011) (No. 09-56965), 2010 WL 4316250. In an amicus brief submitted by several public pension funds in the 2004 Dura Pharmaceuticals v. Broudo Supreme Court case, the institutional investors averred that, notwithstanding the oversight of regulators such as the Commission, “the ability of investors to seek to redress corporate wrongdoing through class and individual actions brought under the Securities Act of 1933 and the Securities Exchange Act of 1934 is an important mechanism to deter improper conduct and to recoup losses that investors have suffered as a result of fraud and other misconduct.” *See* Brief of City of N.Y. Pension Funds et al. as Amici Curiae Supporting Respondents, Dura Pharms. Inc. v. Broudo, 544 U.S. 336 (2005) (No. 03-932), 2004 WL 2652613 (statutory citations omitted).

[15] *See supra* note 14.

[16] For example, there is no *stare decisis* or *collateral estoppel*—no legal precedents, and no questions that have been asked and answered. This is an inefficient use of resources because it provides no guidance to other shareholders in virtually identical disputes against the same company, to other companies looking for guidance on their conduct, or to shareholders in other companies.

[17] *See* Jennifer J. Johnson & Edward Brunet, *Critiquing Arbitration of Shareholder Claims*, 36 Sec. Reg. L. J. 181, n. 89 and accompanying text (2008).

[18] *See* Tom Zanki, *SEC Chief 'Not Anxious' to Deter Post-IPO Class Actions*, Law360 (February 6, 2018, 4:42 PM) https://www.law360.com/articles/1009613/sec-chief-not-anxious-to-deter-post-ipo-class-actions (referring to remarks given by SEC Chairman Jay Clayton at a Senate hearing).