Keeping Shareholders on the Beat: A Call for a Considered Conversation About Mandatory Arbitration

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Thank you so much, Gianna [McCarthy], for that very kind introduction. I'm so glad to be back home here in New York. It's an incredible honor to be speaking after Mayor Bloomberg today. And I'm sure the Mayor will be pleased to know that I plan to return and speak in New York often, if only so I can get a decent slice of pizza.[1]

I was born in the Bronx, just a few subway stops from here, to a big Irish Catholic family. My father was one of five kids and my mother was one of nine, and I've got dozens of cousins spread all around New York. In fact, it would be great if you could keep the news that I'm in town just among us. Otherwise, I'm going to have to spend the rest of the week visiting everyone.

My mom has three older brothers, one of whom served for decades as a transit cop and then a detective in the NYPD. My Uncle Jim worked mostly in local precincts not so far from where he grew up, and today his son, my cousin Jason, is carrying on that tradition, serving with pride in the NYPD.

I've thought about them a lot during my first few dizzying weeks at the SEC. That's because, for all the publicity our rulemaking receives, the bread-and-butter daily work of the SEC is enforcing the securities laws. I spend most of my time with the incredible SEC staff who, all around the country, bring cases against corporate insiders who try to defraud average investors. They're the cops on the beat of the financial world, and play a critical role in ensuring that our markets are the safest and strongest in the world.

Let me tell you—having spent time with the cops on the beat, both in the NYPD and at the SEC, I've learned a lot about how hard their job is. And if I've learned one thing, it's this: whether on the street or in the securities markets, the cops can't do it alone. We need multiple layers of protection. That's especially true in the financial sector, where investors are often the last line of defense keeping insiders from committing fraud. Insiders who would cheat investors know that, if they're caught, shareholders can sue—and they'll have their day in court.

That's why I've been so concerned about the recent rumors that the securities industry is eager to slip mandatory arbitration of shareholder disputes into an upcoming IPO.[2] The idea is that our Division of Corporation Finance will be forced to approve the IPO, stripping shareholders of their right to their day in court—and radically altering the balance between shareholders and corporate insiders.

I've expressed a great deal of skepticism about proposals like these in the past; as I told the Senate in October, I do not have the sense that what we have in corporate America today is too much accountability.[3] And, for reasons I'll get to in a moment, recent changes in the landscape have made me more, not less, concerned about this idea.

Now, I realize that others may have different views.[4] But I think we can all agree that the way to decide this isn't through a clandestine effort by corporate lobbyists. Whatever the SEC decides, we should do it only through a careful, public rulemaking process. In short: if we're going to take away investors' right to their day in court, I hope my colleagues on the Commission can agree that we should, at least, do so in the light of day.[5]

How We Police Corporate Wrongdoing

As you all know well, there are two principal ways we hold corporate managers to account when they hurt investors. First, the government can identify the wrongdoing and bring a case. Second, investors themselves can bring a lawsuit against the responsible individuals and companies.

Government enforcement is crucial to the functioning of our securities markets, and I'm proud to work alongside the best securities enforcement team in the world. I see the results of their hard work each week in the Commission's private enforcement meetings, and I am heartened by their dedication and commitment to protecting investors. At the same time, I'm struck again and again by the sheer audacity of fraudsters and by the devastating amount of money investors lose. Almost daily, I am reminded that our world-class enforcement attorneys cannot do it all alone.

That's why the Supreme Court has said for years that policing corporate wrongdoing is a team effort—the government and investors working together to make sure insiders who betray investors are held to account.[6] Nowhere is this more clear than in the area of shareholder recovery of losses from fraud. For example, in 2016, roughly sixty cents of every dollar returned to investors in corporate-fraud cases came through private rather than SEC settlements.[7] And giving investors their day in court is even more important when the stakes are highest—such as in the wake of a significant corporate fraud. For example, after scandals at Worldcom, Enron, Tyco, Bank of America, and Global Crossing, investors recovered more than $19.4 billion in private lawsuits. By contrast, the SEC obtained $1.75 billion.[8]

Shareholder suits also help us at the SEC identify and address corporate wrongdoing. In fact, in important empirical work scholars have observed that investor lawsuits are as good, if not better, than the government in targeting certain securities-law violations.[9]

My colleagues in the Division of Enforcement do invaluable work every day protecting investors. But there are limits to what they can do—especially today, when the SEC's budget is frozen and fraudsters are finding new ways to harm investors.[10] Our enforcement efforts are straining against the limits of the SEC's resources.[11] And recent judicial developments have made the job of our enforcement staff harder than ever before. The Supreme Court's recent ruling in *Kokesh v. SEC*, for example, has prevented the SEC from recovering hundreds of millions of dollars that, in the past, could have been returned to investors.[12]

So it comes as no surprise to me that shareholders are now working harder than ever to enforce our securities laws. More federal securities-fraud suits were filed in 2017 than in any year since 1995.[13] As my colleague Rick Fleming, the SEC's Investor Advocate, noted in a speech over the weekend, "[b]ecause 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."[14] That has never been more true than it is today.

The Costs of Keeping Corporate Justice in the Dark

So now—when SEC enforcement is hamstrung by budgetary and legal limits—is hardly the time to be thinking about depriving shareholders of their day in court. But there's another reason why I'm so skeptical of proposals like these: they deprive the public of the law our judges make when they hold corporate insiders accountable to investors.

You see, the resolution of private disputes in public courts creates positive externalities.[15] In other words, the public also benefits when private litigants use courts because a public hearing gives judges a chance to tell corporate insiders what the law expects of them. Holding wrongdoers to account tells the public that we take corporate fraud seriously—and sends a signal to insiders, the bar, and investors, that being unfaithful to investors doesn't pay. Arbitration, on the other hand, is usually conducted in a closed-door proceeding, depriving investors of their chance to air their objections—and the rest of us the knowledge of what the law is.[16]

That's especially true when it comes to the fiduciary duties managers owe to their investors. One reason, of course, is that we have the benefit of the expertise of the courts of Delaware. Indeed, one of the many costs of proposals to bring shareholder lawsuits into the dark is that they would deprive the public of the many investor protections developed in state courts.[17] Those protections would not exist if the underlying disputes had been privately arbitrated.

Of course it's true that lawsuits have their own costs. But let's be clear: steps have already been taken to address those concerns. For example, Congress chose to limit the scope of investor lawsuits in federal court over twenty years ago.[18] And the Delaware courts have also put in place limitations on shareholder litigation that companies and shareholders can use today.[19]

Those changes occurred only after careful, public analysis of the arguments on both sides.[20] They were the product of careful consideration of the views of the millions of investors who are the reason why we're all here. They weren't the result of a one-sided process initiated by corporate lobbyists. We should all agree, as we always have, that investors deserve better than that.

The Path Ahead

So how do we move forward from here? For starters, we'll need rigorous answers to the many legal questions raised by any policy proposal requiring investors to rely on private arbitration rather than the courts. What would the effect of SEC action in this area be for state law? What would the Delaware courts say about the relationship between forced arbitration and a board's fiduciary duties?[21] Would our approval of such provisions even be consistent with the federal securities laws?[22]

And what would be the practical effect for SEC enforcement priorities—especially at a time when our regulators are increasingly being asked to do more with less? If investors are soon barred from bringing suits in court, then the burden of investigating and litigating these cases may fall entirely on the SEC. How much would Congress need to appropriate to make sure we have enough resources to do the job?

Given the sheer scale of private enforcement of our securities laws, I'm skeptical that the government could ever fully prevent corporate wrongdoing on its own. So to evaluate proposals like these, we'd also need to know: what would it cost our markets, and the investors who rely on them, to face more frequent corporate fraud?[23]

These are just a handful of the issues that we'll need to confront. I'm sure that many of you in this room could point to many more—and I fully expect that we'll hear a wide range of views. That's why we would need considered public input to make sure we fully understand the costs of proposals like these. A model that we at the SEC would do well to consider is the detailed empirical work that supported the CFPB's arbitration rule. Surely public investors deserve a similar level of deliberation if we are considering taking away a fundamental mechanism for fighting corporate fraud.

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Before I joined the SEC, my research and teaching focused on corporate governance: how to give managers incentives to build the kind of sustainable value that makes American markets the envy of the world. What I've learned in my first few weeks on the job, though, is that the most important thing we can do to create those incentives is to make sure that corporate crime doesn't pay.

There will always be short-run scam artists who seek to steal rather than create long-term value. As my uncle, my cousin, and first responders everywhere know, it's also an unfortunate truth that, as hard as we try, we will never be able to prevent every fraud or catch every crook.

That's why I'm so skeptical about handcuffing the investors who play such an important role in detecting fraud. But whatever path we choose, we should choose it in broad daylight. We can't allow lobbyists to manipulate this process to exclude investor voices. The true cops on the corporate-law beat deserve better than that.

I'm deeply grateful for the chance to be here with you for these important conversations about the long-term future of our companies and our markets, and I look forward to the rest of our day together. Thank you very much.

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[1] I am, as always, grateful to my SEC colleagues Matthew Cain, Caroline Crenshaw, Marc Francis, Satyam Khanna, and Prashant Yerramalli. Professor Stephen Choi of the NYU School of Law also provided insight and evidence that significantly deepened my thinking about these matters. The views expressed here are solely my own, and do not necessarily reflect those of the Staff or my colleagues on the Commission, though I hope someday they will.

[2] Benjamin Bain, *SEC Weighs a Big Gift to Companies: Blocking Investor Lawsuits*, Bloomberg News (January 26, 2018).

[3] *See* U.S. Sen. Comm. on Banking, Housing, and Urban Affairs, *Nominations Hearing* (Tuesday, October 24, 2017), Tr. at 49-51 (question of Sen. Cortez-Masto) ("Mr. Jackson, [are forced arbitration clauses] something that you think the SEC would . . study[? MR JACKSON]: Senator, I do not have the sense that what we have in corporate America is too much accountability.").

[4] *Compare* Sarah N. Lynch, *U.S. SEC's Piwowar Urges Companies to Pursue Mandatory Arbitration Clauses*, Reuters Business News (July 17, 2017); *see also* United States Department of the Treasury, A Financial System that Creates Economic Opportunities: Capital Markets 34 (2017).

[5] Louis Brandeis, Other People's Money—and How Bankers Use It 92 (1914).

[6] *Tellabs, Inc. v. Makor Issues & Rights, Ltd.,* 551 U.S. 28, 313 (2007) ("[The Court] has long recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission."); *see also J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964) (private rights of action under the securities laws are a "necessary supplement to Commission action.").

[7] Cornerstone Research, Securities Class Action Settlements: 2016 Review and Analysis 1 (2016) (noting that, in 2016, federal courts approved approximately $6 billion in securities class-action settlements); *compare* U.S. Securities and Exchange Commission, SEC Announces Enforcement Results for FY 2016 (Oct. 11, 2016) (noting that the SEC obtained just over $4 billion in disgorgement and penalties in FY 2016).

[8] *See* AFL-CIO Executive Council Statement, Investors Must Have Access to the Courts to Prevent Corporate Wrongdoing (July 30, 2014).

[9] Stephen Choi & Adam Prichard, *SEC Investigations and Securities Class Actions: An Empirical Comparison*, 13 J. Emp. Legal Stud. 27 (2016).

[10] *See* Melanie Waddell, *SEC Seeks Budget Boost to Restore Staff*, ThinkAdvisor (February 12, 2018) ("The [SEC's] annual appropriations has remained essentially flat from 2016 to 2018, at $1.6 billion. However, during the same period, securities trading has grown by more than $3 trillion, assets under management by investment advisors has jumped more than $5 trillion, and there's been a 17% growth in ETFs and mutual funds.").

[11] According to New York University's Securities Enforcement Empirical Database, for example, "[t]he number of new [SEC] actions against public-company related defendants decreased by 33 percent in FY 2017." NYU Pollack Center for Law and Business & Cornerstone Research, Securities Enforcement Empirical Database Annual Report (November 14, 2017).

[12] 137 S. Ct. 1365, 1640 (2017).

[13] Cornerstone Research, Securities Class Action Filings: 2017 Year in Review 1, *available at* http://securities.stanford.edu/research-reports/1996-2017/Cornerstone-Research-Securities-Class-Action-Filings-2017-YIR.pdf.

[14] Rick Fleming, Investor Advocate, U.S. Securities and Exchange Commission, *Mandatory Arbitration: An Illusory Remedy for Public Company Shareholders* (Feb. 24, 2018).

[15] For a classic account of the value of public justice, see Jerry L. Mashaw, *The Supreme Court's Due Process Calculus for Administrative Adjudication in* Mathews v. Eldridge*: Three Factors in Search of a Theory of Value,* 44 U. Chi. L. Rev. 28 (1976)). For a more recent, and exceptionally insightful, assessment of this dynamic, see Judith Resnick, *Diffusing Disputes: The Public in the Private of Arbitration, the Private in Courts, and the Erasure of Rights*, 124 Yale L.J. 2804, 2932-39 (2015).

[16] In Bentham's words, in this way public proceedings are the "very soul of justice." Jeremy Bentham, *An Introductory View of the Rationale of Evidence* (1827), *in* 6 The Works of Jeremy Bentham 356 (John Bowring ed., Edinburgh, Tait 1843). It's true, of course, that we at the SEC might be able to craft an arbitration process that addresses some of these these concerns, for example by requiring arbitrators' decisions to be published and their proceedings to be public. But that's all the more reason why we need a careful, deliberative process in this area—rather than an effort to open the door to mandatory arbitration by slipping provisions into IPO filings.

[17] For canonical examples of investor protections developed as common law by Delaware's expert judiciary, see *In re Caremark Int'l Inc.,* 698 A.2d 959 (Del. Ch. 1996); *Smith v. Van Gorkom,* 488 A.2d 858 (Del. 1985).

[18] Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.)

[19] *See, e.g.*, *City of Providence v. First Citizens BancShares, Inc.*, 99 A.3d 229 (Del. Ch. 2014) (addressing exclusive-forum bylaws); *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, 73 A.3d

934 (Del. Ch. 2013) (addressing board-adopted forum-selection bylaws).

[20] Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 103d Cong., 1st Sess. (June 17 & July 21, 1993); Richard Koppes, *A Proposal to Repeal Exclusive Forum at Chevron*, Harv. Law Sch. Forum on Corp. Gov. & Fin. Reg. (May 30, 2012) (discussing the lengthy public debate over forum-selection bylaws).

[21] *See* Barbara Black, *Eliminating Securities Fraud Class Actions Under the Radar,* 2009 Colum. Bus. L. Rev. 802, 838-42 (2009).

[22] More than five years ago, the SEC's Staff indicated that mandatory-arbitration provisions may not comply with federal securities law. *See* Securities and Exchange Commission, Letter to Pfizer, Inc., 2012 WL 587597. I share that concern. *See, e.g.*, Letter of Twenty-Nine Professors of Corporate and Securities Law to Mary Jo White, Chair, U.S. Securities and Exchange Commission, Regarding Arbitration Provisions (October 30, 2013).

[23] Supporters of mandatory-arbitration provisions often argue that investors, aware that the company has adopted these provisions, can adjust the price they pay for the company's shares at the IPO stage. As I have said before, "I am unconvinced that the IPO markets we have today reflect the kind of efficiency that argument demands." Robert J. Jackson, Jr., U.S. Securities and Exchange Commission, *Perpetual Dual-Class Shares: The Case Against Corporate Royalty* (February 15, 2018). In these remarks, however, I am making a narrower claim. At a minimum, these proponents should provide the Commission with evidence of that efficiency before we make significant changes in the way we enforce the federal securities laws on the assumption that they are right.