United States Senate
WASHINGTON, DC 20510

May 3, 2018

The Honorable Jay Clayton
Chair
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Dear Chair Clayton:

We are concerned by recent reports that the Securities and Exchange Commission (SEC) is considering allowing companies seeking to go public to include provisions in their organizational documents requiring mandatory arbitration of shareholder disputes.[1] By denying investors their right to sue in the courts, mandatory arbitration would remove a critical remedy for harmed investors and significantly reduce the accountability of wrongdoers who break the law. Recognizing these problems, the SEC staff has historically viewed mandatory-arbitration clauses as violating the "antiwaiver" provisions of the securities laws, which ensure that investors do not waive their rights under the law.[2] We are aware of your recent letter to Representative Maloney in which you indicate a decision in the context of a registered initial public offering by a U.S. company would involve Commission action. We are concerned by the uncertainty that your response creates, and we urge you to uphold the SEC's historical position and confirm that you will not allow companies to deprive investors of their day in court.

Congress, the Supreme Court, and the SEC alike have long recognized that private litigation is a necessary complement to public enforcement of the securities laws. The Court first recognized investors' right to hold corporate insiders accountable over fifty years ago,[3] and since then, the Court has repeatedly reaffirmed the importance of this right, calling it an "essential tool."[4] Congress endorsed this view in passing the bipartisan Private Securities Litigation Reform Act of 1995, noting that private lawsuits are "an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action."[5] "Such private lawsuits," Congress explained, "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."[6] SEC Chairs and Commissioners of both parties have expressed

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[1] *See* Benjamin Bain, SEC Weighs a Big Gift to Companies: Blocking Investor Lawsuits, Bloomberg (Jan. 26, 2018), https://www.bloomberg.com/news/articles/2018-01-26/trump-s-sec-mulls-big-gift-to-companies-blocking-investor-suits.

[2] *See* Gannett Co., SEC No-Action Letter (Feb. 22, 2012); Pfizer, Inc., SEC No-Action Letter (Feb. 22, 2012); Kevin Roose, Carlyle Drops Arbitration Clause from I.P.O. Plans, N.Y. Times (Feb. 3, 2012), https://dealbook.nytimes.com/2012/02/03/carlyle-drops-arbitration-clause-from-i-p-o-plans.

[3] *See* J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964).

[4] Basic, Inc. v. Levinson, 485 U.S. 224, 231 (1988); *see also* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 28, 313 (2007) (noting that 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").

[5] H.R. Conf. Rep. 104-369, 104th Cong., 1st Sess. 1995, 1995 WL 709276, at *31.

[6] *Id.*

similar sentiments. Republican SEC Chair Richard Breedon, for example, echoed the Court and Congress in calling private actions "a necessary supplement" and "an essential tool."[7]

Private lawsuits are necessary in part because the SEC simply lacks the resources to police all wrongdoing. As the SEC's Investor Advocate put it, "the limited scope of the SEC's resources" has meant that "investors themselves have typically borne a large share of the responsibility for policing the markets and rooting out misconduct."[8] In your testimony before the Senate Banking Committee in February, you recognized those resource constraints as well when you called staffing, especially in the Division of Enforcement, your "biggest challenge."

Private lawsuits also contain features that make them especially well adapted to compensating investors for their losses. While the SEC can usually recover only ill-gotten gains and assess penalties, shareholder actions can obtain compensatory damages. Indeed, private lawsuits have returned more money to investors than SEC enforcement actions. Commissioner Robert Jackson recently noted that "in 2016, roughly sixty cents of every dollar returned to investors in corporate-fraud cases came through private rather than SEC settlements."[9] Overall, from 1996 through 2016, courts approved securities class action settlements totaling over $91 billion,[10] compared with about $46 billion for SEC enforcement actions.[11]

Mandatory arbitration is not, as some claim, an effective alternative to shareholder litigation. The class action mechanism, which mandatory-arbitration clauses eliminate, is essential to aggregate public-company shareholders' relatively small claims into something worth suing over. Shareholders are far too dispersed, and each investment likely too small, to make it worthwhile for an investor to go at it alone. In the words of retired Seventh Circuit Judge Richard Posner, "The *realistic* alternative to a class action is not 17 million individual suits, but zero individual suits, as only a lunatic or a fanatic sues for $30."[12] This problem is especially acute for securities litigation, which is very costly to conduct. Additionally, mandatory-arbitration clauses often contain other provisions that harm investors, such as confidentiality restrictions that keep violations in the shadows.[13]

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[7] 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).

[8] Rick Fleming, Mandatory Arbitration: An Illusory Remedy for Public Company Shareholders (Feb. 24, 2018), https://www.sec.gov/news/speech/fleming-sec-speaks-mandatory-arbitration; *see also* Robert J. Jackson, Jr., Keeping Shareholders on the Beat: A Call for a Considered Conversation About Mandatory Arbitration (Feb. 26, 2018), https://www.sec.gov/news/speech/jackson-shareholders-conversation-about-mandatory-arbitration-022618 (observing that the SEC's "world-class enforcement attorneys cannot do it alone").

[9] *See* Jackson, *supra* note 8.

[10] Cornerstone Research, Securities Class Action Settlements: 2016 Review and Analysis 1, fig.1 (2017), http://securities.stanford.edu/research-reports/1996-2016/Settlements-Through-12-2016-Review.pdf.

[11] Aggregated disgorgement and civil money penalties as reported by the SEC, supplemented by data from Urska Velikonja, Professor of Law at Georgetown University, for missing years.

[12] Carnegie v. Household Int'l, Inc., 376 F.3d 656, 661 (7th Cir. 2004).

[13] *See, e.g.*, Steven Davidoff Solomon, Carlyle Readies an Unfriendly I.P.O. for Shareholders, N.Y. Times (Jan. 28, 2012), https://dealbook.nytimes.com/2012/01/18/carlyle-readies-an-unfriendly-i-p-o-for-shareholders.

This dismantling of class actions would disproportionately harm Main Street investors. Federal Reserve data show that median family ownership of stocks was $25,000 in 2016.[14] A retail investor will not spend tens or hundreds of thousands of dollars bringing an action that recovers a few thousand dollars in damages. Eliminating class actions would thus ensure that only big hedge funds and other well-heeled institutions have access to justice.[15]

Supporters of mandatory arbitration sometimes frame the issue as one of "shareholder choice." This argument misses the mark because it ignores the mandatory structure of the securities laws. In designing the Securities and Securities Exchange Acts, Congress did not make reporting company compliance with disclosure requirements optional.[16] As academics have persuasively argued, there was good sense to this decision because disclosure is a public good.[17] If companies could simply "opt out," there would be a significant underproduction of information, hurting investors, market efficiency, capital formation, and the public interest. Focusing only on the costs of securities class actions ignores their broader benefits to the market as a whole. These broad-based benefits likely explain many institutional investors' strong opposition to mandatory arbitration. The Council of Institutional Investors, for example, explained its opposition as partially a function of "the fact that disputes that go to arbitration rather than the court system generally do not become part of the public record and, thereby, may lose their deterrent effect."[18]

Although we were encouraged by the skepticism you displayed toward mandatory-arbitration clauses at the Banking Committee hearing in February, given the importance of this issue, the SEC should not wait to clarify its position and declare that it intends to maintain its longstanding view against mandatory arbitration clauses. Such clarification would not require you to "prejudge" a specific matter concerning particular entities. The use of mandatory-arbitration clauses is a general policy issue with broad ramifications, and investors should know that the SEC will uphold its longstanding posture.[19]

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[14] Board of Governors of the Federal Reserve System, Federal Reserve Bulletin: Changes in U.S. Family Finances from 2013 to 2016: Evidence from the Survey of Consumer Finances (Sept. 2017), https://www.federalreserve.gov/publications/files/scf17.pdf.

[15] In one high-profile case, hedge fund Aurelius Capital Management, which owned about $468 million worth of debt in Puerto Rico bonds, attempted to block Puerto Rico from restructuring its debts. *See* Aurelius Hedge Fund Seeks to Toss Puerto Rico's Bankruptcy Filing, Reuters (Aug. 7, 2017), https://www.reuters.com/article/us-puertorico-debt-bankruptcy/aurelius-hedge-fund-seeks-to-toss-puerto-ricos-bankruptcy-filing-idUSKBN1AN27H.

[16] *See* Securities Act of 1933 § 14; Securities Exchange Act of 1934 § 29(a).

[17] *See* John C. Coffee, Jr., Market Failure and the Economic Case for a Mandatory Disclosure System, 70 Va. L. Rev. 717 (1984); Merritt B. Fox, Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment, 85 Va. L. Rev. 1335 (1999).

[18] Letter from Jeffrey P. Mahoney, Gen. Counsel, Council of Institutional Investors, to William H. Hinman, Director, SEC Division of Corporation Finance (Jan. 29, 2018), https://www.cii.org/files/issues_and_advocacy/correspondence/2018/January%2029%202018%20letter%20to%20Mr_%20Hinman%20on%20forced%20arbitration%20(final).pdf.

[19] *See* Thomas L. Riesenberg, Arbitration and Corporate Governance: A Reply to Carl Schneider, Insights, Aug. 1990. Mr. Riesenberg, at the time Assistant General Counsel at the SEC, explained in 1990 that "it would be contrary to the public interest to require investors who want to participate in the nation's equity markets to waive access to a judicial forum for vindication of federal or state law rights, where such a waiver is made through a corporate charter rather than through an individual investor's decision." *Id.*

Your recent public comments concern us even further. In remarks to the SEC Investor Advisory Committee on March 8, you stated that you had "not formed a definitive view on whether or not mandatory arbitration for shareholder disputes is appropriate in any particular circumstance," and that you "believe any decision would be facts and circumstances dependent."[20] A facts and circumstances analysis would lie in considerable tension with the mandatory, uniform nature of the securities laws and would represent a significant departure from the SEC's historical position on the application of the antiwaiver provisions. Additionally, at the Council of Institutional Investors conference on March 12, you declined to commit to notice-and-comment rulemaking before allowing mandatory arbitration. Instead, you suggested that you would use some "fair" process without elaborating as to what that process would entail.[21] These comments raise the concern that you might be willing to abandon a critical investor protection and remedy without applying the rigorous processes and analysis that would normally accompany such a major change in policy.

We ask you affirm the SEC's consistent view that mandatory arbitration clauses violate the antiwaiver provisions of the securities laws. Allowing companies to deprive shareholders of their day in court would be a major blow to investor protection, and investors deserve to know the SEC's position on this critical issue.

Sincerely,

Sherrod Brown
United States Senator

Jack Reed
United States Senator

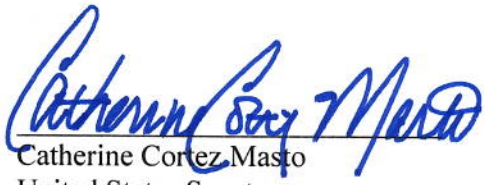
Robert Menendez
United States Senator

Elizabeth Warren
United States Senator

Brian Schatz
United States Senator

Chris Van Hollen
United States Senator

[20] Jay Clayton, Remarks to the SEC Investor Advisory Committee (Mar. 8, 2018), https://www.sec.gov/news/public-statement/statement-clayton-2018-3-8.
[21] The Council of Institutional Investors, Interview with the SEC Chair (Mar. 12, 2018), https://www.youtube.com/watch?v=CV7rb-b4sEM.



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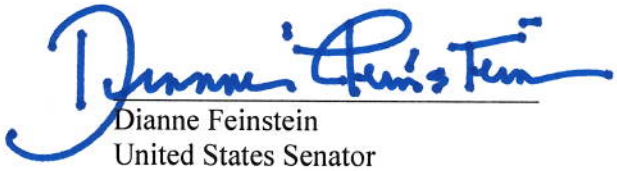

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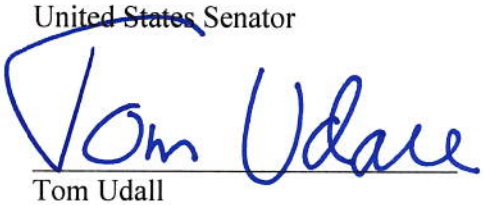

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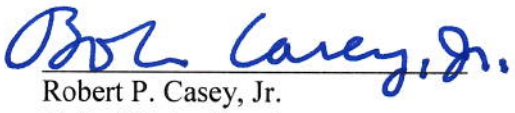

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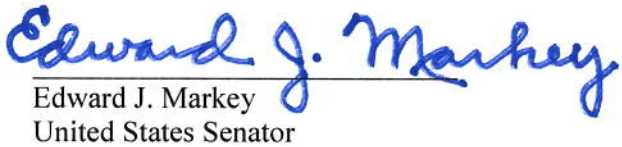

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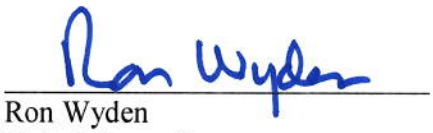

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