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Enforceability of Predispute Arbitration Agreements Under the Federal Securities Laws: *Shearson/American Express, Inc. v. McMahon*

I. Introduction

In *Shearson/American Express, Inc. v. McMahon*,¹ a divided U.S. Supreme Court resolved the controversy which had arisen among the U.S. circuit courts of appeals. At issue was the enforceability of a written agreement between a securities brokerage firm and its customers which stated that any future controversy which might arise between them would be resolved through arbitration² rather than in a judicial forum.³ In accepting this case, the Supreme Court was faced with the task of reconciling the policy of investor protection furthered by the Securities/Exchange Act of 1934⁴ (the "Exchange Act"), with the policy of expeditious and economical resolution of disputes promoted by the Federal Arbitration Act⁵ (the "Arbitration Act"). The *McMahon* Court held that predispute arbitration agreements are enforceable for claims arising under section 10(b) of the Exchange Act. This holding conflicts with case law in eight of the ten circuits which have decided the issue, and reverses a long-standing Second Circuit precedent.⁶

1. 107 S. Ct. 2332, *reh'g denied*, 108 S. Ct. 31 (1987).

2. Black's Law Dictionary defines arbitration as "[t]he reference of a dispute to an impartial (third) person chosen by the parties to the dispute who agree in advance to abide by the arbitrator's award issued after a hearing at which both parties have an opportunity to be heard." BLACK'S LAW DICTIONARY 96 (5th ed. 1979). *See also* S. EAGER, THE ARBITRATION CONTRACT AND PROCEEDINGS § 1 (1971) (arbitration defined as "a proceeding whereby, pursuant to the agreement of parties, disputes or controversies between them, without regard to the justifiable nature thereof, are submitted by them for determination by an individual or individuals rather than by a court or judge acting in a judicial capacity"). Arbitration is not defined in the Arbitration Act.

3. *McMahon*, 107 S. Ct. at 2335. *See infra* note 150 and accompanying text.

4. 15 U.S.C. §§ 78a-78kk (1982) (as amended).

5. 9 U.S.C. §§ 1-14 (1982) (as amended).

6. *See infra* note 187 and accompanying text.

Prior to the passage of the Arbitration Act in 1925, agreements to resolve legal disputes in a forum other than the courts were unenforceable and perceived as attempts to "oust" the courts from their lawful jurisdiction.⁷ However, the Arbitration Act changed judicial perception of this alternate method of dispute resolution by providing that written arbitration agreements are valid and enforceable.⁸ In 1953, despite this strong federal policy favoring arbitration, the Supreme Court's decision in *Wilko v. Swan*⁹ created an exception to the provisions of the Arbitration Act. The Court ruled that predispute arbitration agreements were unenforceable as to claims arising under the Securities Act of 1933¹⁰ (the "Securities Act"). In the wake of *Wilko*, federal courts were faced with the issue of whether to extend this holding to claims arising under the Exchange Act. Without a clear directive from the Supreme Court, during the thirty-two years following *Wilko*, lower federal court decisions resulted in a split among the circuit courts of appeals as to the enforceability of predispute arbitration agreements involving section 10(b) claims brought under the Exchange Act.¹¹

In *McMahon*, the Court not only resolved this long-standing controversy but also reaffirmed its increasingly favorable attitude toward arbitration.¹² However, as strongly as the Court favors arbitration, it did not use *McMahon* as an opportunity to overrule *Wilko*.¹³ Consequently, while predispute arbitration agreements may henceforth be held enforceable for claims brought under the Exchange Act, they remain unenforceable for claims brought under the Securities Act.

Part II of this Note provides background discussions of the Arbitration Act, the Securities Act, and the Exchange Act, and traces the evolution of this important securities issue from its roots in the *Wilko* decision through the confusion that decision spawned in the lower federal courts. The Supreme Court deci-

7. *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 220 n.6 (1985).

8. *McMahon*, 107 S. Ct. at 2337.

9. 346 U.S. 427 (1953).

10. 15 U.S.C. §§ 77a-77aa (1982) (as amended). See *infra* text accompanying note 60.

11. See cases cited *infra* note 187.

12. *McMahon*, 107 S. Ct. at 2338-39.

13. *Id.* at 2341.

sion in *McMahon* is presented in Part III of this Note. Part IV provides a discussion of whether predispute arbitration agreements should be enforceable for claims brought under the Exchange Act. This Note concludes, in Part V, that predispute arbitration agreements are properly enforceable for claims arising under the Exchange Act and that Securities Act claims may soon also be subject to such agreements.

II. Background

A. *The Federal Arbitration Act*

Most securities brokers and dealers require that investors sign an agreement detailing the nature and terms of an investment and the legal relationship between the broker and investor.¹⁴ The investment agreement that an individual investor commonly enters into frequently contains an arbitration clause. The standard arbitration clause, designed to anticipate all likely disputes which might develop between the investor and the broker, states that any controversy which may subsequently arise concerning the account will be resolved through arbitration.¹⁵

Arbitration is favored as a means of dispute resolution because it is generally less expensive and less time consuming than litigation.¹⁶ Fees are greatly reduced in arbitration because there is no discovery or motion practice, and awards are generally con-

14. 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 (July 2, 1979).

15. Arbitration clauses commonly state:

Any controversy between you and the undersigned arising out of or relating to this contract or the breach thereof, shall be settled by arbitration, in accordance with the rules, then obtaining, of either the Arbitration Committee of the Chamber of Commerce of the State of N.Y., or the American Arbitration Association or the Board of Arbitration of the N.Y. Stock Exchange, as the undersigned may elect.

8A C. NICHOLS, *CYCLOPEDIA OF LEGAL FORMS ANNOTATED* § 8.5862, at 496 (1980).

16. See *Legg, Mason & Co. v. Mackall & Co.*, 351 F. Supp. 1367 (D.D.C. 1972) (the basic purpose of arbitration is to relieve parties from costly litigation and help ease congested court dockets); *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, 271 F.2d 402, 410 (2d Cir. 1959), *cert. dismissed*, 364 U.S. 801 (1960) ("[A]ny doubts as to the construction of the [Arbitration] Act ought to be resolved in line with its liberal policy of promoting arbitration both to accord with the original intention of the parties and to help ease . . . congestion of court calendars."). See generally Note, *The New Federal Arbitration Law*, 12 VA. L. REV. 265 (1926) (summarizing the provisions of the Arbitration Act).

sidered nonappealable.¹⁷ In addition, since arbitration proceedings are private, there is diminished fear among the parties of adverse publicity resulting from the decision.¹⁸

Prior to enactment of the Arbitration Act in 1925, many courts refused to enforce arbitration agreements.¹⁹ However, the Arbitration Act expressly provides that such decisions are no longer valid. Section 2 of the Arbitration Act mandates that "a written provision in . . . a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."²⁰ If an action is brought before a court involving an issue which may be referred to arbitration, the court must stay litigation of the action pending arbitration.²¹ As a preliminary matter, the review-

17. Robbins, *A Practitioner's Guide to Securities Dispute Resolution*, 535 PRACTICING LAW INST. 17, 22-26 (1986).

18. *Id.* at 25.

19. See, e.g., *Cocalis v. Nazlides*, 308 Ill. 152, 158, 139 N.E. 95, 98 (1923) (The court held the predispute agreement void because it deprived the parties of their guaranteed constitutional rights of access to the courts. In "an executory contract, an agreement that any dispute that may arise under it shall be submitted to arbitration . . . is void." (footnotes omitted)).

20. 9 U.S.C. § 2 (1982). Although this Note is only concerned with predispute arbitration agreements, section 2 of the Arbitration Act also provides for the enforcement of an arbitration agreement with respect to an existing controversy. See, e.g., *Wilko v. Swan*, 346 U.S. 427, 438 (1953) (Jackson, J., concurring) (Arbitration agreements entered into after a controversy has arisen are enforceable.). See generally Note, *Arbitration of Investor-Broker Disputes* 65 CALIF. L. REV. 120, 137-41 (1977) (discussion of arbitration of existing securities disputes). Commerce is defined as:

[C]ommerce among the several States or with foreign nations, or in any Territory of the United States or in the District of Columbia, or between any such Territory and another, or between any such Territory and any State or foreign nation, or between the District of Columbia and any State or Territory or foreign nation

9 U.S.C. § 1 (1982).

21. The Arbitration Act requires that:

If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.

ing court must decide whether a valid arbitration agreement exists between the parties, and whether the claim before the court is governed by the agreement.²² This procedure was illustrated in *Galt v. Libbey-Owens-Ford Glass Co.*,²³ where the Court of Appeals for the Seventh Circuit held that a federal court asked to compel arbitration²⁴ is assigned the limited role of deciding whether an arbitration agreement has been entered into, and, if so, whether that agreement has been breached.²⁵

Supreme Court decisions during the past twenty years have indicated an increasingly favorable attitude toward arbitration. In *Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*,²⁶ the Court stated that it must honor not only the "plain meaning of the [Arbitration Act] but also the unmistakably clear congressional" intent that a contract to arbitrate be upheld and "not subject to delay and obstruction in the courts."²⁷

The Court expressed its acceptance of arbitration again in *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*,²⁸ where it stated that a federal court should "move the parties to an arbitrable dispute out of court and into arbitration

9 U.S.C. § 3 (1982).

22. The Arbitration Act states:

The court shall hear the parties, and upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed [with] arbitration If the making of the arbitration agreement or the failure, neglect, or refusal to perform the same be in issue, the court shall proceed summarily to the trial thereof.

9 U.S.C. § 4 (1982). In *Miller v. Drexel Burnham Lambert, Inc.*, the court stated:

[A] court may not order arbitration until it is satisfied that a valid arbitration agreement exists. Any claim of fraud, duress or unconscionability in the formation of the arbitration agreement is a matter for judicial consideration Allegations of unconscionability in the contract as a whole, however, are matters to be resolved in arbitration.

791 F.2d 850, 854 (11th Cir. 1986).

23. 376 F.2d 711 (7th Cir. 1967).

24. An order denying a motion to compel arbitration is appealable under 28 U.S.C. § 1292(a)(1) (1982) "as an interlocutory decision refusing an injunction in an action requesting legal relief." *Surman v. Merrill Lynch, Pierce, Fenner & Smith*, 733 F.2d 59, 61 (8th Cir. 1984).

25. *Galt*, 376 F.2d at 714 (quoting *Reconstruction Finance Corporation v. Harrison & Crosfield*, 204 F.2d 366, 368 (2d Cir. 1953)).

26. 388 U.S. 395 (1967).

27. *Id.* at 404.

28. 460 U.S. 1 (1983).

as quickly and easily as possible.”²⁹ The Court stated that the Arbitration Act represents a “liberal federal policy favoring arbitration agreements” which creates a “body of federal substantive law of arbitrability, applicable to any arbitration agreement within the coverage of the [Arbitration] Act.”³⁰ Finally, the Court indicated that “any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration. . . .”³¹

In *Southland Corp. v. Keating*,³² the Supreme Court was called upon to examine a California court’s determination that the arbitration agreement at issue was unenforceable. The state court had based its decision upon a California statute which invalidated such arbitration agreements.³³ Relying on its decision in *Moses H. Cone*,³⁴ the Court held that the Arbitration Act preempted state courts from limiting arbitration, and stated that “[c]ontracts to arbitrate are not to be avoided by allowing one party to ignore the contract and resort to the courts.”³⁵

Recently, in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*,³⁶ the Supreme Court reaffirmed the trend toward arbitration by ruling that a federal antitrust dispute, based on an international trade agreement, was subject to arbitration.³⁷ The Court stated that it must first be determined whether the parties agreed to arbitrate the dispute.³⁸ In making this determination, a reviewing court must examine any claims of “fraud or overwhelming economic power that would provide

29. *Id.* at 22. The arbitration agreement at issue in *Moses H. Cone* was contained in a construction contract. *Id.* at 4.

30. *Id.* at 24.

31. *Id.* at 24-25. See also *Galt*, 376 F.2d at 714-15 (arbitration agreements should be liberally construed and any doubts as to the enforceability of the agreement resolved in favor of arbitration).

32. 465 U.S. 1 (1984).

33. *Id.* at 3. “Any condition, stipulation or provision purporting to bind any person acquiring any franchise to waive compliance with any provision of this law or any rule or order hereunder is void.” *Id.* at 10 (quoting CAL. CORP. CODE § 31512 (West 1977)).

34. 460 U.S. at 1.

35. *Southland*, 465 U.S. at 7.

36. 473 U.S. 614 (1985).

37. *Id.* at 640. *Accord*, *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974) (holding predispute arbitration agreements enforceable in an international dispute). See *infra* text accompanying notes 95-118.

38. *Mitsubishi*, 473 U.S. at 626.

grounds 'for the revocation of any contract.'"³⁹ In the absence of these factors, an agreement to arbitrate should be enforced. The Court also stated that actions founded on statutory rights are not automatically exempt from arbitration, and that the Arbitration Act provides no basis for disfavoring such agreements.⁴⁰ Finally, the Court concluded that "[h]aving made the bargain to arbitrate, the party should be held to it unless Congress itself has evinced an intention to preclude a waiver of judicial remedies for the statutory rights at issue."⁴¹

The liberal pro-arbitration stance adopted by the Court in *Prima*, *Moses H. Cone*, *Southland*, and *Mitsubishi*, accords well with the intent of Congress, evidenced in the Arbitration Act, to expedite the settlement of claims and ease burdensome congestion in the courts.⁴² Once it has been determined that a valid arbitration agreement exists, the only additional limitation on the availability of arbitration is that there be an underlying commercial transaction.⁴³ Since violations of the federal securities laws clearly involve matters of commerce, all federal securities claims are potentially subject to the Arbitration Act.

B. *The Securities Act of 1933 and the Wilko Doctrine*

1. *The Securities Act*

Although it may appear that the provisions of the Arbitration Act are enforceable in all situations where a valid arbitration agreement exists, exceptions have been recognized. One such exception involves the Securities Act.

The Securities Act regulates the original issuance of securities. The primary purpose of the Securities Act is to protect the investor.⁴⁴ Protection is accomplished by compelling disclosure of all material information in public offerings, preventing fraud and misrepresentation in the interstate sale of securities, and granting investors access to a judicial forum to resolve any disputes which may arise in connection with the investment activ-

39. *Id.* at 627 (quoting 9 U.S.C. § 2 (1982)).

40. *Id.*

41. *Id.* at 628.

42. See *supra* note 16 and accompanying text.

43. See *supra* note 20 and accompanying text.

44. *Wilko v. Swan*, 346 U.S. at 427, 431 (1953).

ity.⁴⁵ Protection against fraudulent acts is afforded the investor, in part, through the express liability provision contained in the Securities Act. Section 12(2) provides the investor with a "special right"⁴⁶ to recover for misrepresentation by the seller of a security.⁴⁷ The right has been deemed "special" because, contrary to common law, the defendant seller bears the burden of proving that no misrepresentation has taken place.⁴⁸

Under the section 22(a) jurisdiction provision of the Securities Act, an investor may seek enforcement of a section 12(2) claim in any court of competent jurisdiction against a broker who has misrepresented or omitted information involving the sale of securities.⁴⁹ This right provides the investor with all the advantages normally afforded in an action brought in the federal courts, including a broad choice of venue and the availability of nationwide service of process.⁵⁰ In addition, the Securities Act imposes civil and criminal liabilities for knowing or unreasonable material misstatements or failures to disclose required information.⁵¹ Thus, the enactment of the Securities Act is clear evi-

45. *Id.*; *Reader v. Hirsch & Co.*, 197 F. Supp. 111, 113-14 (S.D.N.Y. 1961).

46. *Wilko*, 346 U.S. at 431.

47. The Securities Act states that any person who offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction

15 U.S.C. § 77l(2) (1982).

48. *Wilko*, 346 U.S. at 431. Unlike section 12(2) of the Securities Act, section 10(b) of the Exchange Act places the burden on the purchaser to prove the seller's culpability.

49. Any suit brought under the Securities Act may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took place, if the defendant participated therein, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found.

15 U.S.C. § 77(a) (1982).

50. *Id.*

51. 15 U.S.C. §§ 77k, 77l(2), 77o (1982) (civil liabilities); 15 U.S.C. § 77x (1982) (criminal penalties).

dence of Congress' strong policy of investor protection.

2. *The Wilko Doctrine — Arbitration Agreements Are Not Enforceable For Securities Act Claims*

In 1953, Congress' policy of investor protection clashed directly with its emerging policy in favor of enforcing arbitration agreements. As a result, in *Wilko v. Swan*,⁵² the Supreme Court carved out an exception to the Arbitration Act for claims arising under the Securities Act.⁵³

In *Wilko*, an investor brought suit against the partners in a securities brokerage firm to recover damages under section 12(2) of the Securities Act.⁵⁴ The investor claimed that the brokerage firm had induced him to purchase shares of stock by falsely representing the value of the stock.⁵⁵ The investor's contract with the brokerage firm included a standard arbitration clause,⁵⁶ and the respondent, without answering the complaint, moved to stay the trial pursuant to section 3 of the Arbitration Act⁵⁷ until arbitration was held.⁵⁸ A divided Second Circuit held that the Securities Act did not prohibit the use of predispute arbitration agreements.⁵⁹

The Supreme Court reversed the Second Circuit, holding that predispute arbitration agreements are void as to claims arising under the Securities Act.⁶⁰ The majority decision was based on a number of factors. First, the Court noted that the

52. 346 U.S. 427 (1953).

53. *Id.* See *Miller v. Drexel Burnham Lambert, Inc.*, 791 F.2d 850, 852 (11th Cir. 1986) (claims under section 12(2) of the Securities Act are "clearly not arbitrable").

54. *Wilko*, 346 U.S. at 428.

55. *Id.* at 428-29.

56. The arbitration clause at issue in *Wilko* stated:

Any controversy arising between us under this contract shall be determined by arbitration pursuant to the Arbitration Law of the State of New York, and under the rules of either the Arbitration Committee of the Chamber of Commerce of the State of New York, or of the American Arbitration Association, or of the Arbitration Committee of the New York Stock Exchange or such other Exchange as may have jurisdiction over the matter in dispute, as I may elect. Any arbitration hereunder shall be before at least three arbitrators.

Id. at 432 n.15.

57. See *supra* note 22.

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

59. *Wilko v. Swan*, 201 F.2d 439, 445 (2d Cir.), *rev'd*, 346 U.S. 427, 430 (1953).

60. *Wilko*, 346 U.S. at 438.

policy behind the the Securities Act was to protect investors, adding to the "ancient rule of *caveat emptor*, the further doctrine of 'let the seller also beware'"⁶¹ The Court stated that this policy was effectuated through section 12(2), which "created a special right" to recover for misrepresentation in any court of competent jurisdiction.⁶² The Court emphasized that this special right differs from comparable common-law actions in that it relieves the investor of the burden of proving scienter and grants the investor a wide choice of venue and nationwide service of process.⁶³

The majority in *Wilko* recognized the competing policies behind the Securities Act and the Arbitration Act — investor protection versus a speedy and economical resolution of disputes.⁶⁴ The majority also noted that the Arbitration Act established "the desirability of arbitration as an alternative to the complications of litigation."⁶⁵ However, relying on section 14 of the Securities Act, the Court held that an investor's rights to a trial under the Securities Act may not be waived.⁶⁶ The section 14 nonwaiver provision specifically provides that "[a]ny condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the [Securities and Exchange] Commission shall be void."⁶⁷ The Court concluded that a predispute arbitration agreement is a "stipulation" that "waives compliance" with the provisions of section 22(a) of the Securities Act, which allows the investor the right to select the judicial forum.⁶⁸ The Court reasoned that, although a buyer and a seller of securities may deal at arm's length in some situations, such is

61. *Id.* at 430 (citing H.R. REP. NO. 85, 73d Cong., 1st Sess. 2 (1933)).

62. *Id.* at 431.

63. *Id.*

64. *Id.* at 438.

65. *Id.* at 431. "The reports of both houses on [the Arbitration] Act stress the need for avoiding the delay and expense of litigation, and practice under its terms raises hope for its usefulness both in controversies based on statutes or on standards otherwise created." *Id.* at 431-32 (footnotes omitted).

66. *Id.* at 435.

67. 15 U.S.C. § 77n (1982).

68. *Wilko*, 346 U.S. at 434-35. Specifically, section 22(a) of the Securities Act affords the plaintiff a choice of state or federal judicial forums, a broad choice of venue, and nationwide service of process. 15 U.S.C. § 77v(a) (1982). See *supra* note 49; see *infra* note 88.

not always the case.⁶⁹ Indeed, "the Securities Act was drafted with an eye to the disadvantages under which buyers labor."⁷⁰ Recognizing that "[i]ssuers of and dealers in securities have better opportunities to investigate and appraise" the business plans affecting securities than do buyers, the Court deemed it "reasonable for Congress to put buyers of securities covered by [the Securities] Act on a different basis from other purchasers."⁷¹

It is clear that a waiver of the right to a trial would cause a securities investor to forego not only the special right afforded him by statute, but also certain procedural advantages available at trial. The adjudication of a securities claim through arbitration "requires . . . findings on the purpose and knowledge of an alleged violator of the [Securities] Act. [Such findings] must be not only determined but applied by the arbitrators without judicial instructions on the law."⁷² Further, since the arbitrators' decision does not require an explanation of their reasoning or a "complete record of [the] proceedings, the arbitrators' conception of the legal meaning of such statutory requirements as 'burden of proof,' 'reasonable care' or 'material fact,' . . . cannot be examined."⁷³ Also, the power to vacate an arbitral award is limited.⁷⁴ An arbitration award may only be vacated upon the showing of a gross abuse of discretion or upon a showing of fraud, bias, or corruption.⁷⁵ Based on the foregoing, the Court con-

69. *Wilko*, 346 U.S. at 435.

70. *Id.*

71. *Id.*

72. *Id.* at 435-36.

73. *Id.* at 436.

74. *Id.*

75. The Arbitration Act states:

[T]he United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration —

(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, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced.

(d) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.

cluded that while the policies behind the Arbitration Act and the Securities Act are "not easily reconcilable," the "intention of Congress concerning the sale of securities is better carried out by holding invalid [a predispute] agreement for arbitration of issues arising under the [Securities] Act."⁷⁶

Disagreeing with the majority's mistrust of arbitration, the dissent in *Wilko* stated that there is nothing to indicate that the arbitral system "would not afford the plaintiff the rights to which he is entitled."⁷⁷ In support of this position, the dissenting Justices stated that the advantages of the Arbitration Act — "a speedier, more economical and more effective enforcement of rights" — coupled with the fact that the arbitrators are required to follow the law by rendering their decisions in accordance with the provisions of section 12(2) of the Securities Act, led to the conclusion that a valid arbitration agreement should have been upheld.⁷⁸

C. *The Securities Exchange Act of 1934*

The Exchange Act extends the policy of investor protection formulated in the Securities Act by regulating the trading of securities subsequent to their original issuance.⁷⁹ The primary purpose of the Exchange Act is to protect interstate commerce and the national credit, to ensure a fair and honest market for the trading of securities,⁸⁰ and "to protect [securities] investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets. . . ."⁸¹ The Exchange Act and the Securities Act collectively "constitute interrelated components of the federal regulatory scheme governing transactions in securities"⁸² and collectively

(e) where an award is vacated and the time within which the agreement required the award to be made has not expired the court may, in its discretion, direct a rehearing by the arbitrators.

9 U.S.C. § 10 (1982).

76. *Wilko*, 346 U.S. at 438.

77. *Id.* at 439 (Frankfurter & Minton, JJ., dissenting).

78. *Id.* at 439-40.

79. 15 U.S.C. §§ 78a-78kk (1982).

80. *Id.*

81. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) (citing S. REP. NO. 792, 73d Cong., 2d Sess. 1-5 (1934)).

82. *Ernst & Ernst*, 425 U.S. at 206. See also *Blue Chip Stamps v. Manor Drug*

further the congressional purpose of "protect[ing] investors against false and deceptive practices that might injure them."⁸³

The Exchange Act contains numerous provisions analogous to those found in the Securities Act. Specifically, the provisions relating to civil liability, jurisdiction, and nonwaiver are remarkably similar, albeit not identical.

Similar to the section 12(2) civil liability provision of the Securities Act, section 10(b) of the Exchange Act prohibits the use of manipulative or deceptive devices in the purchase or sale of securities.⁸⁴ Pursuant to its rulemaking authority under section 10(b) of the Exchange Act, the Securities and Exchange Commission (the "Commission") promulgated Rule 10b-5 for the purpose of identifying practices that violate section 10(b).⁸⁵ Touted as a "'catchall' clause," section 10(b) "enable[d] the Commission 'to deal with new manipulative [or cunning] devices.'"⁸⁶ Unlike section 12(2), section 10(b) does not expressly provide for a private right of action; however, case law has implied such a right.⁸⁷

The jurisdictional provision of the Exchange Act, though similar to the Securities Act provision, is more restrictive. Section 27 of the Exchange Act grants exclusive jurisdiction to the federal courts, while section 22 of the Securities Act provides concurrent jurisdiction between the federal and state courts.⁸⁸

Stores, 421 U.S. 723, 727-30 (1975) (describing the Securities Act and the Exchange Act as "two landmark statutes regulating securities").

83. *Ernst & Ernst*, 425 U.S. at 198.

84. 15 U.S.C. § 78j(b) (1982). See generally *Ernst & Ernst*, 425 U.S. at 197-201 (discussion of scienter requirement in an action for damages under § 10(b)).

85. 17 C.F.R. § 240.10b-5 (1987).

86. *Ernst & Ernst*, 425 U.S. at 203.

87. *Id.* at 196. ("Although Section 10(b) does not by its terms create an express civil remedy for its violation, . . . the existence of a private cause of action for violations of the statute and the Rule is now well-established.") (footnote omitted). *Accord Blue Chip Stamps*, 421 U.S. at 730; *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946). See generally *Herman & MacLean v. Huddelston*, 459 U.S. 375, 380-81 n.10 (1983) (summarizes the implied right of action under § 10(b)). Unlike the implied right under § 10(b) of the Exchange Act, § 12(2) of the Securities Act expressly provides for a civil remedy. See *supra* note 47 for text of § 12(2).

88. Section 22(a) of the Securities Act provides in relevant part that federal courts "shall have jurisdiction of offenses and violations under this [title] and under the rules and regulations promulgated by the Commission in respect thereto, [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 [title]." 15 U.S.C. § 77v(a) (1982). Conversely, sec-

Finally, the nonwaiver provisions of the statutes are almost identical. Both section 14 of the Securities Act and section 29(a) of the Exchange Act prohibit any condition which would bind an individual to waive compliance with any provision contained in the statutes.⁸⁹

1. *Extension of the Wilko Doctrine to Exchange Act Claims*

Since the Supreme Court's ruling in *Wilko* that claims arising under the Securities Act are not arbitrable, uncertainty has surfaced among the courts as to whether predispute arbitration agreements are enforceable for claims arising under the Exchange Act. Generally, federal courts have extended the *Wilko* doctrine to claims arising under the Exchange Act.⁹⁰ An early example of this practice is *Reader v. Hirsch & Co.*⁹¹ Supporting its application of the *Wilko* doctrine to an Exchange Act claim, the *Reader* court stated that the forum clause and nonwaiver provisions in the Exchange Act are equivalent to those found in the Securities Act.⁹² Additionally, the court weighed the benefits

tion 27 of the Exchange Act provides in relevant part that federal courts "shall have exclusive jurisdiction of violations of this [title] or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this [title] or the rules and regulations thereunder." 15 U.S.C. § 78aa (1982).

89. See *supra* text accompanying note 67 for text of section 14 of the Securities Act. Section 29(a) of the Exchange Act provides: "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void." 15 U.S.C. § 78cc(a) (1982).

90. See, e.g., *Surman v. Merrill Lynch, Pierce, Fenner & Smith*, 733 F.2d 59, 61 (8th Cir. 1984) (Although the issue was not before the court, *Surman* stated that lower federal courts have consistently held that *Wilko* applies to claims arising under the Exchange Act.); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1030 (6th Cir. 1979) (*Wilko* doctrine applies to claims under the Exchange Act). See also *Merrill Lynch, Pierce, Fenner & Smith v. Moore*, 590 F.2d 823 (10th Cir. 1978) (policy of non-waiver provision of Securities Act is embodied in Exchange Act non-waiver provision); *Sibley v. Tandy Corp.*, 543 F.2d 540 (5th Cir. 1976), *cert. denied*, 434 U.S. 824 (1977) (The similarities between the Securities Act and the Exchange Act outweigh the differences, and therefore *Wilko* applies to both acts.); *Newman v. Shearson, Hammill & Co.*, 383 F. Supp. 265 (W.D. Tex. 1974) (The reasoning in *Wilko* applies to claims brought under the Exchange Act.); SECURITIES ACTS AMENDMENTS OF 1975, H.R. REP. NO. 229, 84th Cong., 1st Sess. 111, reprinted in 1975 U.S. CODE CONG. & ADMIN. NEWS 179, 342 (The 1975 amendments to the Exchange Act do not alter existing law under the *Wilko* doctrine.).

91. 197 F. Supp. 111 (S.D.N.Y. 1961).

92. *Id.* at 115-16.

of arbitration against its potential disadvantages.⁹³ The *Reader* court concluded that the "abandonment of the buyer's right to choose his forum, and potential abandonment of other rights under the [Exchange] Act . . . can offer the buyer no greater advantage than exists under the [Exchange] Act," and in fact may prove to operate only to his disadvantage.⁹⁴

2. *The Supreme Court Casts Doubt on the Applicability of the Wilko Doctrine to Exchange Act Claims*

Prior to *McMahon*, the Supreme Court had not ruled on whether the reasoning espoused in *Wilko* was applicable to the Exchange Act. However, two recent Supreme Court cases implied that such agreements *may* be enforceable. In *Scherk v. Alberto-Culver Co.*,⁹⁵ the Supreme Court examined this issue and carved out a special niche for predispute arbitration agreements in an international agreement.⁹⁶ *Scherk* involved an international commercial transaction for the sale of a business through the purchase of securities.⁹⁷ The purchase contract contained an agreement to arbitrate all disputes before the International Chamber of Commerce in France.⁹⁸ Alberto-Culver, the purchaser of the securities, alleged fraudulent misrepresentation in violation of section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder.⁹⁹ The Court weighed various factors, including the potential effects of its decision on international trade and the protective policy behind the federal securities laws, before holding (in a five to four decision) that the arbitration agreement contained in the purchase contract was enforceable.¹⁰⁰

In reaching its decision, the Court stated, in dictum, that a

93. *Id.* at 116.

94. *Id.*

95. 417 U.S. 506 (1974).

96. *Id.* at 519-20.

97. *Id.* at 508.

98. *Id.* The contract for the sale of the business entities owned by Scherk stipulated that the laws of the State of Illinois, Alberto-Culver's principal place of business, would apply in any arbitration proceeding. *Id.*

99. *Id.* at 509.

100. *Id.* at 519-20. Chief Justice Burger and Justices Stewart, Blackmun, Powell, and Rehnquist comprised the majority, with Justices Douglas, Brennan, White, and Marshall dissenting. *Id.* at 507.

"colorable argument" could be made that the *Wilko* doctrine does not apply to claims brought under the Exchange Act because the language of the Exchange Act differs from the language of the Securities Act.¹⁰¹ The majority reasoned that there is no provision in the Exchange Act which is analogous to section 12(2) insofar as section 12(2) provides a "special right of a private remedy."¹⁰² Neither section 10(b) nor Rule 10b-5 expressly provides a private remedy to redress violations.¹⁰³ The *Scherk* Court further stated that, while federal case law has established that section 10(b) and Rule 10b-5 create an implied private cause of action,¹⁰⁴ "the [Exchange Act] itself does not establish the 'special right' that the Court in *Wilko* found significant."¹⁰⁵ Additionally, while both the Securities Act and the Exchange Act contain sections barring waiver of compliance with any "provisions" of such statutes (section 14 and section 29(a), respectively),¹⁰⁶ the Securities Act provision which the *Wilko* Court held nonwaivable has no actual counterpart in the Exchange Act.¹⁰⁷ The Court noted that the forum provision contained in section 22 of the Securities Act allows the plaintiff to bring suit in any court of competent jurisdiction, but the analogous provision contained in section 27 of the Exchange Act provides federal district courts with "exclusive jurisdiction" in such matters.¹⁰⁸ The Court reasoned that the Exchange Act "significantly restrict[s] the plaintiff's choice of forum," and therefore does not contain the broad forum selection options which the *Wilko* Court stated could not be waived.¹⁰⁹

The Court's decision in *Scherk*, however, did not rely on the differences in the language between the Securities Act and the

101. *Id.* at 513.

102. *Id.*

103. *Id.*

104. *Id.* See *supra* note 87 and accompanying text.

105. *Scherk*, 417 U.S. at 513-14.

106. See *supra* note 89.

107. *Scherk*, 417 U.S. at 514.

108. *Id.* See *supra* note 88.

109. *Scherk*, 417 U.S. at 514. See *Phillips v. Merrill Lynch, Pierce, Fenner & Smith*, 795 F.2d 1393, 1397 (8th Cir. 1986) (The jurisdictional provision of the Exchange Act is narrower than that found in the Securities Act.), *cert. denied*, 107 S. Ct. 3218 (1987). But see *Conover v. Dean Witter Reynolds, Inc.*, 794 F.2d 520, 527 (9th Cir. 1986) (exclusive jurisdiction of Exchange Act cases is a strong indication that the courts have preference for such cases being under their control), *vacated*, 107 S. Ct. 3203 (1987).

Exchange Act, nor did it explicitly decide whether the *Wilko* doctrine should be extended to claims under the Exchange Act.¹¹⁰ Rather, the Court upheld the enforceability of the arbitration agreement by distinguishing the relevant facts at bar from those surrounding the *Wilko* case.¹¹¹ The Court stated that the "crucial difference" between *Scherk* and *Wilko* was the fact that *Scherk* involved an international agreement and that "[s]uch a contract involves considerations and policies significantly different from those found controlling in *Wilko*."¹¹² The Court emphasized that arbitration agreements between parties to an international agreement are necessary to maintain the orderliness and predictability essential to international business transactions.¹¹³ A contractual provision such as an agreement to arbitrate, which specifies in advance the forum where disputes shall be litigated and the law to be applied, "obviates the danger that a dispute under the agreement might be submitted to a forum hostile to the interests of one of the parties or unfamiliar with the problem area involved."¹¹⁴ Consequently, the *Scherk* decision did not overrule *Wilko*, but created a limited exception applicable only to international transactions.¹¹⁵

Justice Douglas, dissenting in *Scherk*, emphasized the Securities Act's purpose of investor protection.¹¹⁶ The dissent explained that the nonwaiver provision of section 29(a), coupled with the loss of rights associated with arbitration proceedings, dictates that the international aspects of an agreement should not deprive an investor of the protection afforded by the courts.¹¹⁷ It concluded that when a defendant has "brought itself within the ken of federal securities regulation, . . . those laws — including the controlling principles of *Wilko* — apply

110. *Scherk*, 417 U.S. at 515-19.

111. *Id.* at 515.

112. *Id.*

113. *Id.* at 516.

114. *Id.* (footnote omitted). "A parochial refusal by the courts of one country to enforce an international arbitration agreement would not only frustrate these purposes, but would invite unseemly and mutually destructive jockeying by the parties to secure tactical litigation advantages." *Id.* at 516-17.

115. *Newman*, 383 F. Supp. at 268.

116. *Scherk*, 417 U.S. at 523-24. Justice Douglas delivered the dissenting opinion in which Justices Brennan, White, and Marshall joined.

117. *Scherk*, 417 U.S. at 527 (Douglas, J., dissenting).

whether the defendant is foreign or American, and whether or not there are transnational elements in the dealings."¹¹⁸

In *Dean Witter Reynolds, Inc. v. Byrd*,¹¹⁹ the Supreme Court was once again afforded the opportunity to address the issue of enforceability of predispute arbitration agreements under the Exchange Act, and once again the Court declined to resolve the issue.¹²⁰ In *Byrd*, an investor brought suit against a securities broker-dealer alleging violations of sections 10(b), 15(c), and 20 of the Exchange Act as well as violations of various state law provisions.¹²¹ Upon entering into the investment, Byrd signed a standard customer contract which included an arbitration agreement.¹²² Dean Witter filed a motion to sever the pendent¹²³ state claims, compel arbitration of same, and stay arbitration of those claims pending resolution of the federal court action.¹²⁴ Dean Witter argued that the Arbitration Act required the Court to compel arbitration of the state law claims.¹²⁵ However, Dean Witter assumed that the arbitration agreement did not govern the federal securities claim, and therefore did not move to compel arbitration of that claim.¹²⁶ As a consequence of Dean Witter's failure to ask the Court to compel arbitration of the federal securities claim, the question of whether the *Wilko* doctrine applies to the Exchange Act was not properly before the Court and could not be ruled upon.¹²⁷

118. *Id.* at 533.

119. 470 U.S. 213 (1985).

120. *Id.* at 223.

121. *Id.* at 214 (citing 15 U.S.C. §§ 78j(b), 78o(c), 78t (1982)).

122. *Byrd*, 470 U.S. at 215.

123. Pendent jurisdiction is defined in BLACK'S LAW DICTIONARY 1021 (5th ed. 1979): "Original jurisdiction resting under federal claim extends to any nonfederal claim against same defendant if the federal question is substantial and the federal and nonfederal claims constitute a single cause of action." See generally Note, *UMW v. Gibbs and Pendent Jurisdiction*, 81 HARV. L. REV. 657 (1968).

124. *Byrd*, 470 U.S. at 215.

125. *Id.* Dean Witter based this argument on section 2 of the Arbitration Act. *Id.* See *supra* text accompanying note 20 for text of section 2 of the Arbitration Act.

126. *Byrd*, 470 U.S. at 215. As support for this belief, the Court cited *Wilko* and stated that, despite the Supreme Court's recent doubts regarding the *Wilko* doctrine's applicability to the Exchange Act, "*Wilko* has retained considerable vitality in the lower federal courts." *Id.* at 215-16 n.1.

127. *Id.* at 215. "In the District Court, Dean Witter did not seek to compel arbitration of the federal securities claims. Thus, the question whether *Wilko* applies to § 10(b) and Rule 10b-5 claims is not properly before us." The Court further stated that although

The issue in *Byrd* thus became “whether to compel arbitration of the pendent state-law claims when the federal court will in any event assert jurisdiction over a [related] federal-law claim. . . .”¹²⁸ First, the *Byrd* Court rejected the “intertwining doctrine,” which states that when “arbitrable and nonarbitrable claims arise out of the same transaction, and are sufficiently intertwined factually and legally, the district court . . . may in its discretion deny arbitration as to the arbitrable claims and try all the claims together in federal court.”¹²⁹ Next, relying on the legislative history of the Arbitration Act, the court noted that the goal of the Arbitration Act is to “ensure judicial enforcement of privately made agreements to arbitrate . . . [rather than] to promote the expeditious resolution of claims.”¹³⁰ Indeed, the House Report accompanying the Arbitration Act clearly states that the Act’s purpose is “to place an arbitration agreement ‘upon the same footing as other contracts, where it belongs,’ . . . and to overrule the judiciary’s longstanding refusal to enforce agreements to arbitrate.”¹³¹ The *Byrd* Court concluded that Congress clearly intended that courts must “rigorously enforce agreements to arbitrate, even if the result is ‘piecemeal’ litigation, at least absent a countervailing policy manifested in another federal statute.”¹³² Based on the foregoing, the *Byrd* Court held that it was obligated to compel arbitration of the pendent arbitrable claims even though bifurcated proceedings would

“Dean Witter and amici representing the securities industry urge us to resolve the applicability of *Wilko* . . . we decline to do so.” *Id.* at 215-16 n.1.

128. *Id.* at 216.

129. *Id.* at 216-17 (footnote omitted). See generally *Belke v. Merrill Lynch, Pierce, Fenner & Smith*, 693 F.2d 1023 (11th Cir. 1982) (discussing intertwining doctrine); *Smoky Greenhaw Cotton Co. v. Merrill Lynch, Pierce, Fenner & Smith*, 785 F.2d 1274, 1279 (5th Cir. 1986) (The purpose of the now rejected intertwining doctrine was to preserve the federal courts’ exclusive jurisdiction over Securities Act claims and to promote efficiency. *Byrd*’s rejection of the intertwining doctrine was founded on a congressional desire to enforce arbitration agreements.), *cert. denied*, 107 S. Ct. 3211 (1987).

130. *Byrd*, 470 U.S. at 219. The Court stated that the Arbitration Act “does not mandate the arbitration of all claims, but merely the enforcement — upon the motion of one of the parties — of privately negotiated arbitration agreements.” *Id.*

131. *Id.* at 219-20 (citing H.R. REP. No. 96, 68th Cong., 1st Sess. 1 (1924)) (footnote omitted).

132. *Id.* at 221. The Court noted that bifurcated or piecemeal litigation might be the result if a court is confronted with a section 12(2) claim under the Securities Act as well as a pendent state law claim. The Court further observed that if *Wilko* were applied to claims arising under the Exchange Act, the same situation would arise. *Id.* at 218 n.5.

result.¹³³

Although the issue of the enforceability of predispute arbitration agreements under the Exchange Act was not squarely before the Court, Justice White, in a concurring opinion, cast "substantial doubt" as to whether such agreements would be found unenforceable.¹³⁴ Relying on the express language of the Securities Act and the Exchange Act, Justice White used reasoning similar to that of the majority in *Scherk* and decided that the provisions, while similar, were not identical and therefore could not produce identical results.¹³⁵ Specifically, Justice White stated that although section 29 of the Exchange Act is equivalent to section 14 of the Securities Act, the Exchange Act counterparts of section 12(2) and section 22 of the Securities Act are "imperfect or absent altogether."¹³⁶ Justice White emphasized that jurisdiction under the Exchange Act is more restrictive than under the Securities Act and that a cause of action under section 10(b) and Rule 10b-5 is implied rather than express.¹³⁷ Lastly, he indicated that "*Wilko's* solicitude for the federal cause of action — the 'special right' established by Congress — is not necessarily appropriate where the cause of action is judicially implied and not so different from the common-law action."¹³⁸ Based on the differences in the express language of the statutes, Justice White concluded that "*Wilko's* reasoning cannot be mechanically transplanted to the [Exchange] Act,"¹³⁹ and therefore, "the contrary holdings of the lower courts must be viewed with some doubt."¹⁴⁰

133. *Id.* at 223-24. For a discussion of *Byrd* and the intertwining doctrine, see Note, Dean Witter Reynolds, Inc., v. Byrd: The Unraveling of the Intertwining Doctrine, 62 DEN. U.L. REV. 789 (1985) (tracing the evolution of the conflict regarding the intertwining doctrine and discussing the arguments presented in *Byrd*).

134. *Byrd*, 470 U.S. at 224 (White, J., concurring). Justice White participated in the dissenting argument in *Scherk*. See *supra* text accompanying notes 116-118. His opinion in *Byrd* therefore represents a reversal, at least in part, of his view on this issue.

135. *Byrd*, 470 U.S. at 224-25 (White, J., concurring).

136. *Id.* at 224.

137. *Id.* at 224-25.

138. *Id.* at 225 (citation and footnote omitted).

139. *Id.* at 224.

140. *Id.* at 225.

3. *Confusion Leads to a Split Among Federal Courts*

Since *Byrd*, most federal district courts that have considered whether predispute arbitration agreements are enforceable for claims arising under the Exchange Act have followed Justice White's concurrence in *Byrd* and held such claims arbitrable.¹⁴¹ Among the circuit courts of appeals, however, predispute arbitration agreements have not fared as well, with the majority of the circuit courts holding the agreements unenforceable with respect to claims brought under the Exchange Act.¹⁴²

The first case involving the arbitrability issue to reach the circuit court level after *Byrd* was *McMahon v. Shearson/American Express, Inc.*¹⁴³ The investor in *McMahon* brought suit against the broker for misrepresentation and "churning"¹⁴⁴ of accounts in violation of the Exchange Act. The action also involved a RICO claim¹⁴⁵ and state law claims for fraud and breach of fiduciary duty.¹⁴⁶

Applying the decision of the Supreme Court in *Byrd*, the Second Circuit in *McMahon* compelled arbitration of the pendent state law claims even though bifurcated proceedings re-

141. *Schriner v. Bear, Stearns & Co.*, 635 F. Supp. 373 (N.D. Cal. 1986); *Fisher v. Prudential-Bache Securities, Inc.*, 635 F. Supp. 234 (D. Md. 1986); *Prawer v. Dean Witter Reynolds, Inc.*, 626 F. Supp. 642 (D. Mass. 1985); *West v. Drexel Burnham Lambert, Inc.*, 623 F. Supp. 26 (W.D. Wash. 1985). *Contra Shapiro v. Merrill Lynch & Co.*, 634 F. Supp. 587 (S.D. Ohio 1986); *Bale v. Dean Witter Reynolds, Inc.*, 627 F. Supp. 650 (D. Minn. 1986).

142. See cases cited *infra* note 187.

143. 788 F.2d 94 (2d Cir. 1986), *rev'd*, 107 S. Ct. 2332, *reh'g denied*, 108 S. Ct. 31 (1987).

144. Churning occurs when a securities broker engages in excessively large and frequent transactions in the investor's account for the purpose of generating commissions, acting in disregard of the client's interest. *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 324 (5th Cir. 1981). To establish a claim for churning, the investor must prove: "(1) the trading in his [investor's] account was excessive in light of his investment objectives; (2) the broker in question exercised control over the trading in the account; and (3) the broker acted with the intent to defraud or with willful and reckless disregard for the investor's interests" *Id.* at 324 (citations omitted). If proven, the broker may be held liable for violations of section 10(b) and Rule 10b-5. *Id.* See generally Note, *Churning by Securities Dealers*, 80 HARV. L. REV. 869 (1967).

145. The Racketeer Influenced and Corrupt Organization Act, 18 U.S.C. § 1962(c), makes it unlawful for a person employed or associated with enterprises engaged in interstate commerce to conduct affairs through a pattern of racketeering activity or collection of unlawful debt. Many of the cases discussed in this Note also involve RICO issues; however, that is beyond the scope of this Note.

146. *McMahon*, 788 F.2d at 95.

sulted.¹⁴⁷ However, a unanimous Second Circuit court refused to compel arbitration of the section 10(b) claim.¹⁴⁸ The court stated that although *Byrd* and *Scherk* "may cast some doubt on whether the Supreme Court, if presented with the issue, would hold claims under §10(b) and Rule 10b-5 to be non-arbitrable, it would be improvident for us to disregard clear judicial precedent in this Circuit based on mere speculation."¹⁴⁹ In support of this ruling, the *McMahon* court looked to the similarity of the provisions of the federal securities acts, to the strong policy concerns inherent in those acts and to the legislative history thereof.¹⁵⁰ Based on this analysis, the court reaffirmed its previous holdings that section 10(b) and Rule 10b-5 claims are not arbitrable.¹⁵¹ Noting that the broad policy questions involved in federal securities law claims require a judicial forum for the resolution of disputes, the *McMahon* court concluded that *Wilko* must be applied to Exchange Act claims.¹⁵²

The Second Circuit again addressed the arbitrability issue

147. *Id.*

148. *Id.* However, the court affirmed the district court's finding that the RICO claims were non-arbitrable. *Id.*

149. *Id.* at 98. The court noted that while many district courts have continued to follow the settled law of the Second Circuit, holding claims under section 10(b) not arbitrable, others have "interpreted . . . *Scherk* and *Byrd* as authority for holding such claims to be arbitrable." *Id.* at 97 n.4 (citing *Leone v. Advest, Inc.*, 624 F. Supp. 297 (S.D.N.Y. 1985); *Weizman v. Adornato*, No. 84 Civ. 3603 (E.D.N.Y. Apr. 25, 1985) (both cases holding claims not arbitrable); *Finkle & Ross v. A.G. Becker Paribas, Inc.*, 622 F. Supp. 1505 (S.D.N.Y. 1985); *Jarvis v. Dean Witter Reynolds, Inc.*, 614 F. Supp. 1146 (D.Vt. 1985) (both cases holding claims to be arbitrable)).

150. *McMahon*, 788 F.2d at 98. The customer agreement signed by McMahon contained the following arbitration provision:

Unless unenforceable due to federal or state law, any controversy arising out of or relating to my accounts, to transactions with you for me or to this agreement or the breach thereof, shall be settled by arbitration in accordance with the rules, then in effect, of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchange, Inc. as I may elect.

Id. at 94.

151. *Id.* at 97. *See, e.g.*, *Greater Continental Corp. v. Schechter*, 422 F.2d 1100, 1103 (2d Cir. 1970) ("question concerning fraud within the meaning of Rule 10b-5 is properly litigated in the courts where a complete record is kept of the proceedings and findings and conclusions are made"); *AFP Imaging Corp. v. Ross*, 780 F.2d 202, 205 (2d Cir. 1985) (arbitration clauses in contracts claims brought under the Exchange Act are "unenforceable under the law of this Circuit"), *cert. denied*, 106 S. Ct. 3295 (1986).

152. *McMahon*, 788 F.2d at 98.

in *Intre Sport Ltd. v. Kidder, Peabody & Co.*¹⁵³ In that case, Intre Sport alleged claims arising under section 12(2) of the Securities Act as well as various common law breaches of contract, breaches of fiduciary duty and fraud.¹⁵⁴ The district court dismissed the section 12(2) claim because it was time-barred and held that the section 10(b) claims were to be arbitrated.¹⁵⁵ The district court reasoned that the doubts raised in *Byrd* and *Scherk*, combined with the Supreme Court's renewed vigor in enforcing agreements to arbitrate under the Arbitration Act,¹⁵⁶ and the significant differences between the substantive rights of action available under the Exchange Act and those available under the Securities Act, compelled a holding which would refer the claims to arbitration.¹⁵⁷ However, as a result of subsequent Second Circuit decisions in *AFP Imaging Corp. v. Ross*¹⁵⁸ and in *McMahon*,¹⁵⁹ which held that section 10(b) claims are not arbitrable, the district court in *Intre Sport* subsequently modified its opinion and reinstated the Exchange Act claims, thereby refusing arbitration.¹⁶⁰ The district court concluded that the "Second Circuit's explicit, if unexplained, endorsement of the continued nonarbitrability of federal securities law claims" must control.¹⁶¹ The Second Circuit affirmed the modified holding without opinion.¹⁶² In so doing, the Second Circuit once again reaffirmed its pre-*Byrd* holdings.

The Ninth Circuit, in *Conover v. Dean Witter Reynolds*,

153. 625 F. Supp. 1303 (S.D.N.Y. 1985), *modified*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,714 (S.D.N.Y. 1986), *aff'd mem.*, 795 F.2d 1004 (2d Cir. 1986), *vacated*, 107 S. Ct. 3203 (1987).

154. *Intre Sport Ltd.*, 625 F. Supp. at 1304.

155. *Id.* at 1312.

156. *See, e.g.*, *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1982) ("[A]ny doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration . . ."); *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.* 473 U.S. 614 (1985) (federal antitrust claims in the international context held not arbitrable).

157. *Intre Sport Ltd.*, 625 F. Supp. at 1315.

158. 780 F.2d 202; *see supra* note 151.

159. 788 F.2d 94; *see supra* text accompanying notes 143-152.

160. *Intre Sport Ltd.*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,714 (S.D.N.Y. 1986).

161. *Id.*

162. *Intre Sport Ltd.*, 795 F.2d at 1004.

Inc.,¹⁶³ joined the majority of circuit courts in holding predispute arbitration agreements unenforceable as to claims brought under the Exchange Act.¹⁶⁴ While the nonarbitrability of section 10(b) claims had already been the rule in the Ninth Circuit,¹⁶⁵ *Conover* was the first post-*Byrd* Ninth Circuit ruling on the issue. In reaching its decision, the court examined the text and the legislative and judicial history of the Exchange Act, with an eye toward the purposes underlying the federal securities laws and the Arbitration Act.¹⁶⁶ Although the court recognized the strong federal policy evidenced in the Arbitration Act, it stated that the Arbitration Act "does not automatically validate an arbitration agreement in the face of contrary congressional policy."¹⁶⁷ The court cited *Wilko* in support of this statement.¹⁶⁸ In determining congressional intent, the court pointed to the non-waiver provisions of the two acts as a clear indication that Congress intended to prohibit waiver of the right to a judicial forum.¹⁶⁹

Because the Exchange Act lacks an express provision for a private right of action under section 10(b), the *Conover* court turned for guidance to the legislative and regulatory history of the Exchange Act.¹⁷⁰ It found that not only is an implied cause of action for section 10(b) claims well established, "its nonwaivable character has become well accepted by the Securities and Exchange Commission, the courts of appeals, and Congress it-

163. 794 F.2d 520 (9th Cir. 1986), *vacated*, 107 S. Ct. 3203 (1987).

164. *Id.* at 527.

165. *Id.* at 521. The court cited post-*Wilko*/pre-*Byrd* Ninth Circuit decisions which held Exchange Act claims non-arbitrable. *Id.* (citing *Kehr v. Smith Barney, Harris Upham & Co.*, 736 F.2d 1283, 1285 n.1 (9th Cir. 1984); *Kershaw v. Dean Witter Reynolds, Inc.*, 734 F.2d 1327, 1328 (9th Cir. 1984); *De Lancie v. Birr, Wilson & Co.*, 648 F.2d 1255, 1257 (9th Cir. 1981)).

166. *Conover*, 794 F.2d at 523-24.

167. *Id.* at 522.

168. *Id.*

169. *Id.* at 523. See *supra* note 89 and accompanying text, and text accompanying note 67. *Accord* *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Moore*, 590 F.2d 823, 827 (10th Cir. 1978); *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831, 835-36 (7th Cir. 1977); *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532, 536 (3rd Cir.), *cert. denied*, 429 U.S. 1010 (1976). All of these cases rely on the similarity between the nonwaiver provisions contained in the Securities Act and the Exchange Act.

170. *Conover*, 794 F.2d at 523-24.

self.”¹⁷¹ In support of this contention, the court observed that, “[i]n 1979, the Securities and Exchange Commission issued [Rule 15c2-2], a release warning broker-dealers that customers should be made aware that they have a right to a judicial forum to pursue claims under both the [Securities] and [Exchange] Acts, notwithstanding their arbitration agreements.”¹⁷² Of further significance to the court was Congress’ failure to eliminate the federal cause of action for section 10(b) claims when the opportunity arose in 1975 during major revisions of the Securities Act and the Exchange Act.¹⁷³

Finally, the *Conover* court noted that, in 1975, Congress expressly recognized the nonarbitrable nature of disputes between brokers and customers¹⁷⁴ by “emphasiz[ing] that its amendment to section 28 of the [Exchange Act], which permitted arbitration agreements between brokers and exchanges, did not extend to arbitration agreements between brokers and customers”¹⁷⁵ The *Conover* court stated that this legislative history demanded a conclusion that predispute arbitration agreements are unenforceable with regard to claims brought under the Exchange Act.¹⁷⁶

The *Wilko* doctrine was the final factor examined by the court in *Conover*. Reviewing the *Wilko* considerations favoring nonarbitrability in the context of the case at bar, the *Conover* court concluded that the *Wilko* doctrine applied with “equal

171. *Id.* at 524; see *supra* note 87.

172. *Conover*, 794 F.2d at 524 (citing 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 (July 2, 1979)). The rule stated:

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, or to have in effect such an agreement, pursuant to which it effects transactions with or for a customer.

17 C.F.R. § 240.15c2-2(a) (1987).

173. *Id.* at 524.

174. *Id.*

175. *Id.* (citing H.R. REP. NO. 229, 94th Cong., 1st Sess. 111, reprinted in 1975 U.S. CODE CONG. & ADMIN. NEWS 179, 321, 342). See *Weissbuch*, 558 F.2d at 836 (“Congress appears to have accepted the view that *Wilko* . . . applies in the 10b-5 context.”); *Ayres*, 538 F.2d at 536-37 (interpreting report the same way).

176. *Conover*, 794 F.2d at 524.

force" to section 10(b) of the Exchange Act.¹⁷⁷ This reasoning was based on the court's opinion that the bargaining position between customers and dealers is the same regardless of which Act the claim falls under. "Dealers are as likely to 'maneuver buyers into a position that might weaken their ability to recover' under the [Exchange] Act as they are under the [Securities] Act."¹⁷⁸ Similarly, the need for judicial supervision to protect parties' rights is as compelling under the Exchange Act as it is under the Securities Act.¹⁷⁹ Additionally, the special jurisdictional and procedural protections afforded by the Securities Act, which the *Wilko* Court found to weigh heavily against arbitrability, are present in the Exchange Act as well.¹⁸⁰ In *Wilko*, the Court stated that a securities customer "surrenders more by agreeing to arbitrate claims under the [Securities] Act than would a person who agrees to arbitrate a normal business transaction claim."¹⁸¹ Similarly, the *Conover* court found that under the Exchange Act, a securities customer has advantages not afforded the average business customer. There is no diversity requirement for a section 10(b) claim, there is no amount in controversy requirement, and the 10(b) plaintiff has greater service-of-process and venue options than does a diversity plaintiff.¹⁸²

Finally, the *Conover* court compared the Exchange Act's jurisdiction provision with the corresponding provision in the Securities Act.¹⁸³ The court noted that "while the [Securities] Act grants concurrent jurisdiction to federal and state courts, the [Exchange] Act vests exclusive jurisdiction in the federal

177. *Id.* at 525.

178. *Id.* (citation omitted).

179. *Id.* at 526 (citation omitted). See *Schechter*, 422 F.2d at 1103 (a "question concerning fraud within the meaning of Rule 10b-5 is properly litigated in the courts where a complete record is kept of the proceedings and findings and conclusions are made."); *Wilko*, 346 U.S. at 436 ("As [the arbitrators'] award may be made without explanation of their reasons and without a complete record of their proceedings, the arbitrators' conception of the legal meaning of . . . statutory requirements . . . cannot be examined.").

180. *Conover*, 794 F.2d at 525.

181. *Id.*

182. *Id.* at 526.

183. *Id.* at 527. The court compared section 27 of the Exchange Act ("any district where the defendant is found, inhabits or transacts business, or 'where any act or transaction constituting the violation occurred' ") with section 22 of the Securities Act ("any district where the defendant is found, inhabits or transacts business, 'or in the district where the offer of sale took place' "). *Id.*

courts.”¹⁸⁴ The court found that this distinction strongly evidenced “Congress’ intent that federal courts oversee the interpretation and application of the [Exchange] Act.”¹⁸⁵ The Ninth Circuit concluded in *Conover* that Congress intended to preclude arbitration agreements under the Exchange Act and that its decision “comports with the legislative history and purposes of the [Exchange] Act, as well as with the Supreme Court’s analysis of similar claims under the [Securities] Act.”¹⁸⁶

Although seven additional circuit courts of appeals have agreed with the Ninth Circuit holding and held predispute arbitration agreements under the Exchange Act unenforceable, the First and Eighth Circuits have declined to follow suit.¹⁸⁷ Relying on the doubts raised in *Scherk* and *Byrd*, and on the strong federal policy favoring the enforcement of arbitration agreements, the Eighth Circuit, in *Phillips v. Merrill Lynch, Pierce, Fenner & Smith*,¹⁸⁸ ruled that claims arising under a violation of section 10(b) of the Exchange Act are arbitrable.¹⁸⁹ The investor in *Phillips*, upon opening a securities account with Merrill Lynch, signed a standard customer agreement which provided that “any controversies relating to the account shall be submitted to arbitration.”¹⁹⁰ Phillips sued the brokerage firm, alleging violations of section 10(b) of the Exchange Act and section 12(2) of the Securities Act.¹⁹¹ Merrill Lynch then moved, pursuant to the

184. *Id.*; see *supra* note 88.

185. *Conover*, 794 F.2d at 527.

186. *Id.*

187. Compare *McMahon v. Shearson/American Express, Inc.*, 788 F.2d 94 (2d Cir. 1986), *rev'd*, 107 S. Ct. 2332, *reh'g denied*, 108 S. Ct. 31 (1987); *Jacobson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 797 F.2d 1197 (3d Cir. 1986), *vacated*, 107 S. Ct. 3204 (1987); *King v. Drexel Burnham Lambert, Inc.*, 796 F.2d 59 (5th Cir. 1986); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017 (6th Cir. 1979); *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831 (7th Cir. 1977); *Conover v. Dean Witter Reynolds, Inc.*, 794 F.2d 520 (9th Cir. 1986), *vacated*, 107 S. Ct. 3203 (1987); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Moore*, 590 F.2d 823 (10th Cir. 1978); *Miller v. Drexel Burnham Lambert, Inc.*, 791 F.2d 850 (11th Cir. 1986) (all holding predispute arbitration agreements unenforceable) with *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), *cert. denied*, 107 S. Ct. 3218 (1987) (holding predispute arbitration agreements enforceable).

188. 795 F.2d 1393 (8th Cir. 1986), *cert. denied*, 107 S. Ct. 3218 (1987).

189. *Id.* at 1399.

190. *Id.* at 1394.

191. *Id.*

parties' arbitration agreement, to compel arbitration of the Exchange Act claim.¹⁹²

In its decision, the *Phillips* court emphasized, that the "centerpiece provision of the . . . Arbitration Act provides that arbitration agreements shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."¹⁹³ According to the court, recent interpretation by the Supreme Court of this and other provisions of the Arbitration Act reflected a "strong federal policy favoring the enforcement of arbitration agreements."¹⁹⁴ Citing *Byrd*, the *Phillips* court noted that "[t]he preeminent concern of Congress in passing the [Arbitration] Act was to enforce private agreements into which parties had entered, and that concern requires that we rigorously enforce agreements to arbitrate."¹⁹⁵

The *Phillips* court found additional support for its decision in *Swink & Co. v. Hereth*,¹⁹⁶ where the Eighth Circuit held that the *Wilko* doctrine does not void arbitration agreements between municipal bond dealers and members of a stock exchange.¹⁹⁷ The court reasoned that the *Swink* holding suggested that *Wilko* should be "contained rather than expanded."¹⁹⁸ The *Phillips* court also pointed to *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*¹⁹⁹ as an illustration of the Supreme Court's recognition of the value of arbitration in a commercial context.²⁰⁰ In *Mitsubishi*, the Supreme Court stated that there is

192. *Id.*

193. *Id.* at 1395. See *supra* text accompanying note 20.

194. *Phillips*, 795 F.2d at 1395.

195. *Id.* n.5.

196. 784 F.2d 866 (8th Cir. 1986).

197. *Id.* at 868. The *Swink* court stated that there is a recognized exception to the *Wilko* Doctrine when the dispute is intra-industry in nature. *Id.* See *Halliburton & Assocs., Inc. v. Henderson, Few & Co.*, 774 F.2d 441 (11th Cir. 1985) (ruling that predispute arbitration agreements are unenforceable with respect to claims under section 12(2) does not apply to disputes between members of the stock exchange).

While the *Phillips* court found support for arbitration in the *Swink*'s reasoning, other courts have indicated that this has no bearing on agreements between brokers and investors. See, e.g., *McMahon*, 788 F.2d at 98 (The Second Circuit has not recognized an exception to the non-arbitrability of securities law claims in circumstances other than disputes between member firms of the stock exchanges.). See also *supra* text accompanying note 175.

198. *Phillips*, 795 F.2d at 1399.

199. 473 U.S. 614 (1985).

200. *Phillips*, 795 F.2d at 1395. But see *Jacobson*, 797 F.2d at 1202. (The issue in

a "strong presumption in favor of freely negotiated contractual choice-of-forum provisions."²⁰¹ The *Mitsubishi* Court further stated that

[b]y agreeing to arbitrate a statutory claim, a party does not forego the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum. It trades the procedures and opportunity for review of the courtroom for the simplicity, informality, and [speed] of arbitration. We must assume that if Congress intended the substantive protection afforded by a given statute to include protection against waiver of the right to a judicial forum, that intention will be deducible from text or legislative history.²⁰²

The *Phillips* court dismissed the applicability of the *Wilko* doctrine to Exchange Act claims with reasoning similar to that found in *Scherk* and *Byrd*, by pointing to differences in the jurisdictional and civil liability provisions of the Securities Act and the Exchange Act.²⁰³ Additionally, the Eighth Circuit stated in *Phillips* that the nonwaiver provision of the Exchange Act "does not override the Arbitration Act in the same manner as section 14 of the [Securities] Act when it is not buttressed by special rights and broad jurisdictional provisions similar to those found in the [Securities] Act."²⁰⁴

Lastly, and perhaps most significantly, the *Phillips* court recognized that while many courts of appeals have held that the *Wilko* reasoning extends to claims arising under the Exchange Act, "[r]ecent Supreme Court pronouncements indicate . . . that this remains an open question."²⁰⁵ The court noted that it was faced with no Eighth Circuit precedent and explained that it would ordinarily avoid creating a conflict among the circuits.²⁰⁶ However, the *Phillips* court continued, the *Scherk* and *Byrd* opinions "invite a reexamination of the applicability of *Wilko* to

Mitsubishi was different because it involved interpretation of arbitration agreements, not federal statutes that prohibit the application of forum selection clauses.).

201. *Mitsubishi*, 473 U.S. at 615.

202. *Id.* at 628.

203. *Phillips*, 795 F.2d at 1397.

204. *Id.* at 1398 (footnote omitted).

205. *Id.* at 1396.

206. *Id.* at 1399-1400.

claims arising under section 10(b) of the [Exchange] Act"²⁰⁷ Based on the foregoing, and in the absence of a contrary Supreme Court holding, the *Phillips* court ruled that predispute arbitration agreements are enforceable for claims arising under the Exchange Act.²⁰⁸

III. Arbitration or Litigation? The Supreme Court Ruling in *Shearson/American Express, Inc. v. McMahon*

In a long awaited opinion written by Justice O'Connor, the Supreme Court, in *Shearson/American Express, Inc. v. McMahon*,²⁰⁹ held that predispute agreements to arbitrate Exchange Act claims are enforceable.²¹⁰ In a five to four opinion, the Court reversed the Second Circuit decision in *McMahon*,²¹¹ and implicitly overruled precedent in seven additional circuits.²¹²

A. The Majority Opinion

Citing *Scherk*,²¹³ *Byrd*,²¹⁴ *Moses H. Cone*,²¹⁵ and *Mitsubishi*,²¹⁶ the Court began its opinion in *McMahon* by stressing the strong federal policy favoring arbitration.²¹⁷ The Court noted that not only is the "duty to enforce arbitration agreements . . . not diminished"²¹⁸ merely because the claim is based on a statu-

207. *Id.* at 1400.

208. *Id.*

209. 107 S. Ct. 2332, *reh'g denied*, 108 S. Ct. 31 (1987). Justice O'Connor delivered the opinion of the Court in which Chief Justice Rehnquist, and Justices White, Powell, and Scalia joined. Justice Blackmun, joined by Justices Brennan and Marshall, filed an opinion dissenting with respect to the arbitrability of Exchange Act claims, but concurred with the holding of the second issue raised in this case — that of the arbitrability of RICO claims. *See supra* note 145. Justice Stevens, in a separate opinion, also concurred in part and dissented in part.

210. *Id.* at 2343.

211. *McMahon v. Shearson/American Express, Inc.*, 788 F.2d 94 (2nd Cir. 1986), *rev'd*, 107 S. Ct. 2332, *reh'g denied*, 108 S. Ct. 31 (1987).

212. Eight circuit courts of appeals — the Second, Third, Fifth, Sixth, Seventh, Ninth, Tenth, and Eleventh — have held predispute arbitration agreements unenforceable for claims arising under the Exchange Act. The First and Eighth Circuits have held such agreements arbitrable. *See cases cited supra*, note 187.

213. *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974).

214. *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213 (1985).

215. *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1 (1983).

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

217. *McMahon*, 107 S. Ct. at 2337.

218. *Id.*

tory right, but the time has passed when “ ‘judicial suspicion of the desirability of arbitration and of the competence of arbitral tribunals’ [will] inhibit enforcement of the [Arbitration] Act. . . .”²¹⁹ With regard to the case before it, the Court explained that, since the burden is on the party opposing arbitration, McMahon “must demonstrate that Congress intended to make an exception to the Arbitration Act for claims arising under . . . the Exchange Act, an intention discernable from the text, history, or purposes of the statute.”²²⁰

Following this rationale, the Court systematically rejected each of McMahon’s arguments. First, the Court rejected the proposition that section 29(a), the nonwaiver provision of the Exchange Act, bars waiver of section 27, the jurisdictional provision.²²¹ The Court explained that although section 29(a) forbids enforcement of agreements to waive “compliance” with provisions of the Exchange Act, “[section] 27 itself does not impose any duty with which persons trading in securities must ‘comply.’ . . . Because [section] 27 does not impose any statutory duties, its waiver does not constitute a waiver of ‘compliance with any provision’ of the Exchange Act under [s]ection 29(a).”²²² In its attempt to reconcile this reasoning with *Wilko*’s²²³ holding that section 14 of the Securities Act bars a waiver of section 22(a), the Court stated that *Wilko*’s conclusion was based on the belief that the rights created by the Securities Act could only be protected in a judicial forum.²²⁴ The *McMahon* Court emphasized that “*Wilko* must be understood . . . as holding that the plaintiff’s waiver of the ‘right to select the judicial forum,’ was unenforceable *only* because arbitration was judged inadequate to enforce the statutory rights created by § 12(2).”²²⁵ However, the Court explained, where arbitration provides an adequate forum for enforcing the Exchange Act’s provisions, section 29(a) will not void the waiver of section 27 of that Act. In support of its conclusion, the *McMahon* Court cited the *Scherk* holding with

219. *Id.* (quoting *Mitsubishi*, 473 U.S. at 627).

220. *McMahon*, 107 S. Ct. at 2337-38.

221. *Id.* at 2338.

222. *Id.*

223. *Wilko v. Swan*, 346 U.S. 427 (1953).

224. *McMahon*, 107 S. Ct. at 2338.

225. *Id.* (emphasis added) (citation omitted).

approval.²²⁶

The Court refused to accept McMahon's argument that arbitration lessens an investor's rights and hence his ability to recover under the Exchange Act,²²⁷ pointing out that *Wilko*'s reasons for mistrusting the arbitral process have subsequently been rejected by the Court.²²⁸ According to the Court, the *Scherk* decision established that arbitral forums are capable of resolving section 10(b) claims in an international context.²²⁹ Moreover, the Court noted that arbitrators are considered competent to resolve section 10(b) claims between members of the Securities Exchange, concluding that the resolution of section 10(b) claims requires the same abilities regardless of who the parties are and whether it is an international or domestic dispute.²³⁰

Finally, the Court disagreed with McMahon's contention that certain action and inaction by Congress over the past years has indicated an intention to void predispute agreements to arbitrate Exchange Act claims.²³¹ In support of this argument, McMahon pointed to Congress' failure during the 1975 revisions of the Exchange Act to provide for the arbitrability of section 10(b) claims.²³² In addition, McMahon identified a conference report, issued during the 1975 amendments to the Exchange Act, which stated that "[i]t was the clear understanding of the conferees that this amendment did not change existing law, as articulated in *Wilko*"²³³ McMahon argued that the conferees were aware of lower court rulings extending *Wilko* to Exchange Act claims, and by this language implicitly approved those rulings.²³⁴

The Court dismissed these arguments by stating first that the 1975 revisions were "intended to 'clarify the scope of the

226. *Id.* at 2339.

227. *Id.* at 2339-40. The *McMahon* court stated that this fear was at the "heart" of the *Wilko* decision. *Id.* The *Wilko* Court was primarily concerned with the fact that arbitrators had to make legal determinations without explanation, reasons, or a written record, and that the arbitrators' decision, barring fraud or disregard of the law, is not subject to "judicial review for error in interpretation." *Wilko*, 346 U.S. at 435-37.

228. *McMahon*, 107 S. Ct. at 2340.

229. *Id.*

230. *Id.* at 2340-41.

231. *Id.* at 2342-43.

232. *Id.* at 2342.

233. *Id.* at 2343 (citing H.R. CONF. REP. No. 229, 94th Cong., 1st Sess. 111, reprinted in 1975 U.S. CODE CONG. & ADMIN. NEWS 179, 342).

234. *Id.* at 2343.

self-regulatory responsibilities of national securities exchanges and registered securities associations . . . and the manner in which they are to exercise those responsibilities.’ ”²³⁵ The revisions failed to mention either customers or arbitration. Therefore, the Court concluded, the revisions were directed at a different problem and consequently had no bearing on this issue. Second, addressing the sentence in the Conference Report quoted by McMahon, the Court found that Congress could not extend *Wilko* to the Exchange Act without enacting a law to that effect.²³⁶ In addition, the “quoted sentence does not disclose what committee members thought ‘existing law’ provided.”²³⁷ It is quite likely, the Supreme Court posited, that Congress thought the law was as espoused in *Scherk* — that it was doubtful that *Wilko* would be extended to 10(b) claims.²³⁸ Based on the foregoing, the Court concluded that “Congress did not intend for section 29(a) to bar enforcement of . . . predispute arbitration agreements”²³⁹ and that, because arbitration is an adequate forum within which parties’ rights in a section 10(b) claim will not be diminished, the arbitration agreements should be held valid.²⁴⁰

B. *The Dissent*

In a strong dissent, Justice Blackmun stated that the majority decision “approves the abandonment of the judiciary’s role in the resolution of claims under the Exchange Act and leaves such claims to the arbitral forum of the securities industry at a time when the industry’s abuses towards investors are more apparent than ever.”²⁴¹ The dissent referred to the current issue as one which had been “kept alive inappropriately”²⁴² by the Supreme Court and indicated that the “colorable argument” advanced in

235. *Id.* at 2342 (quoting S. REP. NO. 75, 94th Cong., 1st Sess. 22 (1975)).

236. *Id.* at 2343.

237. *Id.*

238. *Id.*

239. *Id.*

240. *Id.*

241. *Id.* at 2346 (Blackmun, Brennan, & Marshall, JJ., dissenting in part). See *supra* note 209.

242. *McMahon*, 107 S. Ct. at 2346 (Blackmun, J. dissenting).

Scherk belonged in the "graveyard of ideas."²⁴³ Even the majority was aware of this, the dissent argued, since nowhere in the opinion did they rely on the "colorable argument."²⁴⁴

The dissent articulated three major areas of faulty analysis in the majority's opinion. First, the dissent referred to the 1975 congressional amendments to the Exchange Act. Of significance to the dissent was the conferees' statement that existing law under *Wilko* was not changed by the amendments. This, said the dissent, "on its face indicates that Congress did not want the amendments to overrule *Wilko*. Moreover, the fact that this statement was made in an amendment to the Exchange Act suggests that Congress was aware of the extension of *Wilko* to § 10(b) claims."²⁴⁵ The dissent further stated that, while this sentence is not a conclusive congressional endorsement of this extension, "in the absence of any prior congressional indication to the contrary, it implies that Congress was not concerned with arresting [the] trend."²⁴⁶ The dissent concluded that Congress approved the extension of *Wilko* to Exchange Act claims.²⁴⁷

Next, the dissent stated that the Court read *Wilko* too narrowly in order to fit it "into the syllogism offered by the Commission and accepted by the Court."²⁴⁸ The dissent criticized the majority's finding that the main concern behind the *Wilko* decision was the adequacy of arbitration.²⁴⁹ Citing the prior Supreme Court opinion in *Mitsubishi*, the dissent argued that *Wilko* is properly viewed as standing for the proposition "that the text and legislative history of the Securities Act — not general problems with [a]rbitration," are the reasons claims brought under the Securities Act are excepted from the provisions of the Arbitration Act.²⁵⁰ The dissent emphasized that although *Wilko* discussed the inadequacies of the arbitration process, its holding was actually based on the language, legislative history, and poli-

243. *Id.* at 2347 n.2.

244. *Id.* at 2346-47.

245. *Id.* at 2348.

246. *Id.* (footnote omitted).

247. *Id.* at 2349.

248. *Id.*

249. *Id.* at 2349-50.

250. *Id.* at 2350.

cies underlying the Securities Act.²⁵¹ In support of this contention, the dissent pointed to the Securities Act's purpose of protecting investors and proceeded to engage in an analysis of *Wilko* similar to that found in *Conover*²⁵² and the Second Circuit's decision in *McMahon*.²⁵³ Relying on *Wilko* as a correctly decided case, the dissent drew parallels between the Securities Act and the Exchange Act.²⁵⁴ It stated that the nonwaiver provisions of each Act are "virtually identical," and that both Acts were designed with a "common purpose" in mind — investor protection.²⁵⁵ The dissent argued that a proper reading of *Wilko* leads to the conclusion that "the same reasons that led the Court to find an exception to the Arbitration Act for 12(2) claims exist for §10(b) claims as well."²⁵⁶

Finally, the dissent stated that "the Court accepts uncritically petitioners' and the [Securities and Exchange] Commission's argument that the problems with arbitration, highlighted by the *Wilko* Court, either no longer exist or are now not viewed as problems by the Court."²⁵⁷ The dissent pointedly observed that the majority did not specifically mention exactly what improvements had been made in arbitration since *Wilko*. According to the dissent, although improvements *had* been made in arbitration, "several aspects of arbitration that were seen by the *Wilko* court [sic] to be inimical to the policy of investor protection still remain."²⁵⁸ In support of this statement, the dissent noted that, as in *Wilko*'s time, arbitrators are still not required to produce a record of the proceedings, or an opinion; they are not bound by precedent; and judicial review is only granted on one of the four grounds specified in section 10 of the Arbitration Act.²⁵⁹ At best, the dissent emphasized, an investor will be placed on an equal footing with the securities firm; however, at worst, the investor is forced into a forum controlled by the se-

251. *Id.* at 2352.

252. *Conover v. Dean Witter Reynolds, Inc.*, 794 F.2d 520 (9th Cir. 1986), *vacated*, 107 S. Ct. 3203 (1987).

253. *McMahon*, 107 S. Ct. at 2350-53 (Blackmun, J. dissenting).

254. *Id.*

255. *Id.* at 2353.

256. *Id.*

257. *Id.* at 2350.

258. *Id.* at 2353.

259. *Id.* at 2354-55. See *supra* note 75 for text of § 10 of the Arbitration Act.

curities industry.²⁶⁰ This, the dissent concluded, "directly contradicts the goal of both securities acts to free the investor from the control of the market professional."²⁶¹

IV. Analysis

The inherent conflict between the Arbitration Act and the Exchange Act does not invite easy resolution. The state of disagreement among the circuit courts of appeals, combined with the five to four split in *McMahon*,²⁶² clearly indicates that the scale weighs heavily on both sides.

The policy of enforcing arbitration agreements is generally strong. Not only does the Arbitration Act expressly state that such a provision "shall be valid, irrevocable, and enforceable,"²⁶³ but Supreme Court decisions prior to *McMahon* have demonstrated an increased preference for arbitration.²⁶⁴ In *Byrd*,²⁶⁵ the Court so strongly believed that arbitration agreements should be enforced, that it expressed its willingness to withstand inefficient, piecemeal litigation in order to uphold the arbitration agreement. In *McMahon*, the Court reaffirmed its favorable attitude toward arbitration.

Opposing the applicability of arbitration for claims arising under the Exchange Act are strong policies deeply rooted in the substance and procedure of the federal securities laws. Here, protection of the investor is of paramount concern. In *Wilko*,²⁶⁶ the Court indicated that the goal of investor protection is embodied in the special right created by section 12(2) which allows the investor to recover for misrepresentation in a federal forum. Further protection is afforded through the nonwaiver and forum selection provisions set forth in sections 14 and 22 of the Securities Act, respectively.²⁶⁷ The Supreme Court in *Wilko* stressed that these protections are necessary because of the unequal bar-

260. *McMahon*, 107 S. Ct. at 2355 (Blackmun, J., dissenting).

261. *Id.*

262. *Shearson/American Express, Inc. v. McMahon*, 107 S. Ct. 2332, *reh'g denied*, 108 S. Ct. 31 (1987).

263. *See supra* text accompanying note 20.

264. *See supra* text accompanying note 42.

265. *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213 (1985).

266. *Wilko v. Swan*, 346 U.S. 427 (1953).

267. *See supra* note 88 and text accompanying note 67.

gaining position between the parties.²⁶⁸

Nowhere in the federal securities laws or in the legislative history of such laws is it stated that the investor who purchases securities under the statutory and regulatory framework of the Exchange Act is in need of less protection than the investor who purchases securities regulated under the Securities Act. In *Conover*,²⁶⁹ the Ninth Circuit recognized that "[d]ealers are as likely to 'maneuver buyers into a position that might weaken their ability to recover,' . . . under the [Exchange] Act as they are under the [Securities] Act."²⁷⁰

Why should the courts hold their doors open for one investor but not for another, when they are equally in need of protection? A number of federal courts have answered this question by simply observing that the special right provided a section 12(2) plaintiff does not expressly exist under section 10(b).²⁷¹ However, for more than 40 years courts have found an implied right to a federal cause of action for section 10(b) claims.²⁷² It is clear that the courts, in judicially implying a cause of action for section 10(b) claims, have recognized the necessity for the deterrent effect of private enforcement in a judicial forum. The nonwaiver provisions of both Acts are virtually identical and have not resulted in any discrepancies in the judicial interpretation thereof.²⁷³ Indeed, the Supreme Court in *McMahon* did not rely on a distinction between these two provisions in reaching its decision.

The judicial forum provisions of the two Acts, however, have received differing interpretations. In *Scherk*,²⁷⁴ the Supreme Court indicated that choice of forum is more limited under the Exchange Act (which provides for exclusive jurisdiction of federal courts) than under the Securities Act (which pro-

268. *Wilko*, 346 U.S. at 435.

269. *Conover v. Dean Witter Reynolds, Inc.*, 794 F.2d 520 (9th Cir. 1986), *vacated*, 107 S. Ct. 3203 (1987).

270. *Id.* at 525 (quoting *Wilko*, 346 U.S. at 432).

271. See *supra* note 89 for text of § 29(a) of the Exchange Act and text accompanying note 67 for text of § 14 of the Securities Act.

272. See *supra* note 87 and accompanying text.

273. See *supra* note 89 for text of § 29(a) of the Exchange Act and text accompanying note 67 for text of § 14 of the Securities Act.

274. *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974).

vides for concurrent federal and state court jurisdiction).²⁷⁵ However, in *Conover*, the Ninth Circuit reasoned that the exclusive jurisdiction of federal courts over claims involving the federal securities laws clearly indicates Congress' strong desire to ensure parties access to a federal forum for the resolution of the Exchange Act claims.²⁷⁶ Ultimately, the *McMahon* Court found no significance in the differences between the judicial forum provisions of the two Acts, emphasizing that the jurisdiction provision imposed no "statutory duties" or "substantive obligations."²⁷⁷ Indeed, it was this interpretation of the jurisdiction provisions which allowed the *McMahon* Court to conclude that the nonwaiver provision of the Exchange Act did not apply to the jurisdiction provision of that Act.²⁷⁸

Prior to the *McMahon* decision, the Commission's position on the nonarbitrability of Exchange Act claims seemed clear. Its public statements of policy clearly warned broker-dealers that they should inform customers of their right to a judicial forum under both the Securities Act and the Exchange Act, notwithstanding the existence of arbitration agreements.²⁷⁹ The Commission further clarified its position by issuing Rule 15c2-2, which prohibits broker-dealers from entering into or maintaining agreements with customers purporting to bind them to arbitration pursuant to a predispute arbitration clause.²⁸⁰ However, the Supreme Court claimed that this action was "not based on any independent analysis of §29(a), but instead '[was] premised on . . . court of appeals decisions following *Wilko*, that agreements to arbitrate Rule 10b-5 claims were not, in fact, arbitrable.'" ²⁸¹

Critical to the arbitrability issue are the comparative advantages and disadvantages for the plaintiff-investor inherent in arbitration, as opposed to federal litigation. Arbitration is less ex-

275. *Id.* at 514.

276. *Conover*, 794 F.2d at 527.

277. *McMahon*, 107 S. Ct. at 2338.

278. *Id.*

279. *See supra* notes 171-172 and accompanying text.

280. *See supra* notes 171-172 and accompanying text.

281. *McMahon*, 107 S. Ct. at 2341 n.3 (quoting Brief for the Securities and Exchange Commission as *Amicus Curiae* at 18 n.13, *Shearson/American Express, Inc. v. McMahon*, 107 S. Ct. 2332, *reh'g denied*, 108 S. Ct. 1 (1987)).

pensive and less time consuming, an advantage for both the broker and the investor.²⁸² However, movement away from a federal forum to an arbitration panel may produce a radically different final result. As discussed in *Bernhardt v. Polygraphic Co. of America*,²⁸³

[a]rbitration carries no right to trial by jury . . . Arbitrators do not have the benefit of judicial instruction on the law, [and] they need not give their reasons for their results; the record of their proceedings is not as complete as it is in a court trial; and judicial review of an award is more limited than judicial review of a trial²⁸⁴

"Arbitrators are not bound by the rules of evidence. . . . They may draw on their personal knowledge in making an award. . . . And the arbitrators need not disclose the facts or reasons behind their award."²⁸⁵

As noted earlier, the Supreme Court decision in *McMahon* did not rely primarily on the distinctions between the provisions of the Securities Act and the Exchange Act. Rather, the Court founded its holding primarily upon the change in the nature of arbitration over recent years. The Court emphasized that "the mistrust of arbitration that formed the basis for the *Wilko* opinion in 1953 is difficult to square with the assessment of arbitration that has prevailed since that time."²⁸⁶ Moreover, the Court stated, since the 1975 Amendments to the Exchange Act, "the Commission has had broad authority to oversee and to regulate the rules adopted by the SRO's [Self-Regulatory Organizations] relating to customer disputes, including the power to mandate the adoption of any rules it deems necessary to ensure that arbitration procedures adequately protect statutory rights."²⁸⁷ The Court concluded that "where the [Commission] has sufficient statutory authority to ensure that arbitration is adequate to vindicate Exchange Act rights, enforcement does not effect a waiver of 'compliance with any provision' of the Exchange Act under

282. See *supra* note 17 and accompanying text.

283. 350 U.S. 198 (1956).

284. *Id.* at 203.

285. *Id.* at 203-04 n.4 (citations omitted).

286. *McMahon*, 107 S. Ct. at 2341.

287. *Id.* (footnote omitted).

§ 29(a).²⁸⁸

Clearly, a new era has emerged which favors arbitration. Members of the exchanges may arbitrate claims between themselves; foreign entities may submit disputes with U.S. entities to arbitration; parties may agree to arbitration after a dispute arises; and pendent state law claims may be submitted to arbitration even where the principal federal securities claim is not. *McMahon* holds that claims arising under the Exchange Act may be submitted to arbitration pursuant to a predispute agreement. Consequently, it appears that the only federal securities law claims which may not be submitted to arbitration are those arising under the Securities Act.²⁸⁹

The Supreme Court has not yet effectively explained the distinction regarding the nonarbitrability of Securities Act claims especially in light of its admission that the current arbitration system is a healthy one within which parties may adequately pursue their grievances. The lack of any significant differences between the provisions of the Securities Act and those of the Exchange Act, coupled with the Court's declaration that *Wilko*'s reasoning is antiquated,²⁹⁰ indicates that the Court may believe that Securities Act claims should also be subject to arbitration. The issue of Securities Act claims was not before the Court in *McMahon*; hence, the Court properly relied on "*stare decisis* concerns" as a primary reason for not overruling *Wilko*.²⁹¹ It is likely, however, that when the issue is presented to the Court, it will abandon the *Wilko* doctrine. Indeed, the Court admits, in dicta, that it is difficult to reconcile *Wilko* with its subsequent decisions involving the Arbitration Act.²⁹²

Since Exchange Act claims are subject to arbitration agree-

288. *Id.* at 2343.

289. Because the Supreme Court in *McMahon* did not explicitly overrule *Wilko*, courts that have decided the arbitrability of Securities Act claims have been forced to hold such claims nonarbitrable. See *Chang v. Lin*, 824 F.2d 219, 223 (2d Cir. 1987) (holding litigation of Securities Act claims "should proceed simultaneously" with the arbitration of Exchange Act claims); *Schultz v. Robinson-Humphrey/American Express, Inc.*, No. 85-115, slip op. at 1 (D. Ga. Aug. 14, 1987). "[I]t is this court's considered opinion that the Supreme Court [in *McMahon*] did not overrule *Wilko*, and has implicitly reaffirmed the nonarbitrable nature of Section 12 claims."

290. *McMahon*, 107 S. Ct. at 2341.

291. *Id.*

292. *Id.*

ments, and since Securities Act claims will, in all probability, also be subject to such agreements in the future, it would be provident for Congress to express this intention clearly by amending the securities laws. Congress should specify the roles and duties of the various parties involved. In so doing, it can insure that the basic policies underlying the federal securities laws — investor protection, for example — are best served.

Rather than being contained in a standard “boilerplate” clause buried among other, unrelated provisions, an agreement to arbitrate should be placed on a separate document and presented in a clear and conspicuous manner, with full disclosure of the procedure to be followed and the rights which are being lost. The essential elements of such an agreement should be (1) a clear and conspicuous waiver; (2) knowledge of the rights being waived; and (3) evidence that the agreement was negotiated and entered into freely.

Once it has been determined that the investor knowingly and voluntarily entered into an arbitration agreement, arbitration procedures should be administered fairly and uniformly. To achieve this goal, Congress, in conjunction with the Commission, should devise a plan whereby the Commission would monitor and oversee the arbitration process as guardian of the investor. In conclusion, a valid and fair agreement to resolve a claim in an arbitral forum which does not act to either party’s disadvantage should be upheld as valid, binding, and enforceable. When the investor and the broker meet on the same plane, each should be held to the agreement he bargained for.

V. Conclusion

*McMahon*²⁹³ mandates that predispute arbitration agreements are enforceable for claims arising under the Exchange Act. Prior to this decision, eight of the ten circuit courts which have addressed this issue held such agreements unenforceable. In so holding, the circuit courts extended *Wilko*²⁹⁴ by drawing comparisons between the provisions and policies of the Exchange Act and the Securities Act. The Supreme Court’s hold-

293. *Shearson/American Express, Inc. v. McMahon*, 107 S. Ct. 2332, *reh’g denied*, 108 S. Ct. 31 (1987).

294. *Wilko v. Swan*, 346 U.S. 427 (1953).

ing, however, was based primarily on the improvements in arbitration which it perceived to have occurred since 1953, when *Wilko* was decided.

The ramifications of the Supreme Court decision in *McMahon* are significant. The decision effectively overrules eight circuit courts of appeals, including the Second Circuit which is generally considered the "mother court"²⁹⁵ on securities issues. Further, the Court's holding exemplifies its favorable sentiment toward arbitration. In addition, although the Court does not expressly overrule *Wilko*, it restricts the *Wilko* doctrine to claims arising under the Securities Act.

In the wake of *McMahon*, predispute arbitration agreements are enforceable for claims arising under the Exchange Act, but not for claims arising under the Securities Act. However, similarities between the Exchange Act and the Securities Act, coupled with the Court's favorable attitude toward arbitration, indicate that Securities Act claims may also be subject to arbitration agreements in the near future. The similar language found in the two securities Acts, as well as their common goal of investor protection, indicates that the Acts should be applied similarly. It seems clear that if arbitration is an adequate and fair forum for the resolution of Exchange Act claims, it should also be an adequate forum for the resolution of Securities Act claims. Indeed, the Supreme Court in *McMahon* has cast serious doubt on the continuing viability of *Wilko*, even with respect to Securities Act claims. Support for this conclusion is evident from a careful reading of the Court's opinion. Not only did the Court find the Commission's increased authority to oversee the arbitral process compelling, but it implied that the fears expressed in *Wilko* regarding the inadequacies of the arbitral process, while certainly not valid today, may not have been valid in *Wilko*'s day either. Therefore, it seems highly likely that, when provided the opportunity, the Court will hold all securities claims to be subject to predispute arbitration agreements.

Since claims arising under the federal securities laws will not be exempt from the provisions of the Arbitration Act, every effort must be made to continue to provide for adequate investor protection. Modifications of broker-customer agreements and su-

295. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 761-62 (1975).

pervision of the arbitral process are steps which must be taken to insure the protection of the investor. In response to the Supreme Court's recent endorsement of the arbitral process, Congress must now take measures to assure that, in the steady move towards arbitrability, investors' rights are not being unduly compromised.

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