

A SETTLED MATTER:

Mandatory Shareholder Arbitration Is
Against the Law and the Public Interest

**CONSUMER FEDERATION
OF AMERICA**

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Executive Summary

Congress, the courts, and the Securities and Exchange Commission have all long recognized the “essential” and “necessary” role that private shareholder lawsuits play in deterring fraud in our capital markets and compensating the victims of fraud. In keeping with this view, the SEC has taken a number of actions over the years to prevent public companies from restricting their shareholders’ ability to participate in such lawsuits by adopting mandatory shareholder arbitration provisions in their bylaws or offering documents. Such clauses would strip away shareholders’ rights to hold the companies that they invest in accountable for violations of the securities laws. Instead of allowing shareholders to band together to bring any claims through class actions in federal court, these clauses would require shareholders to litigate any claims individually in a private arbitration proceeding. The practical effect would be to eliminate such claims and lose the essential benefits they offer.

Recently, however, in the wake of a series of pro-arbitration Supreme Court rulings, some academics and corporate lawyers have suggested that corporate issuers should renew their efforts to press for mandatory shareholder arbitration. Press reports have called into question whether the SEC can be relied on to maintain its long-held position of opposition should one or more public companies make a determined effort to adopt mandatory shareholder arbitration.

While SEC Chairman Jay Clayton has stated that the issue is not a priority for him and that he does not intend to take it up, he does not entirely control whether the issue comes before the Commission, and his statements have suggested that he may be sympathetic to the argument in favor of mandatory shareholder arbitration. Moreover, he has indicated that individuals who have strong views on the subject should “support their position with robust, legal and data driven analysis.” This White Paper is designed to provide that requested analysis, showing that mandatory shareholder arbitration is contrary to both the law and the public interest.

The first section of the paper provides background information on investors’ right to redress under federal securities laws, on mandatory arbitration generally, and on the Commission’s response to past attempts by issuers to adopt mandatory shareholder arbitration provisions. The second section of the paper argues that mandatory shareholder arbitration is contrary to the law because it violates the anti-waiver provisions of the federal securities laws and is not compelled by the Federal Arbitration Act (FAA). The third section outlines the many reasons why public policy requires that investors have the ability to pursue private actions in court, the most prominent being the central role such lawsuits play not only in enabling defrauded investors to recover their losses, but also in deterring fraud and misconduct. Finally, the paper discusses a

number of ways in which the issue could arise at the SEC, argues that any efforts to abandon the SEC's long-held position on this issue must comply with both the federal securities laws and the Administrative Procedure Act, and raises additional issues that companies would face if mandatory shareholder arbitration were permitted.

The SEC Has On Several Occasions Disallowed Mandatory Shareholder Arbitration

The role of private lawsuits as a necessary supplement to public enforcement is firmly ensconced in the law. For example, the Supreme Court has declared that “private actions to enforce federal antifraud securities laws are an essential supplement” to governmental actions. Proposals to permit public companies to adopt forced arbitration provisions would eliminate this “indispensable tool,” threatening not only the ability of defrauded investors to recover their losses, but the “public and global confidence in our capital markets” that is a direct benefit of their deterrent effect.

For decades, the SEC has refused to permit U.S. public companies to include mandatory shareholder arbitration clauses in their bylaws or other organizational documents. This has included at least two occasions when the SEC has refused to accelerate IPO filings for companies that sought to include mandatory shareholder arbitration clauses and at least three instances in which the Commission has granted no action relief to companies seeking to exclude proxy proposals to adopt mandatory arbitration. While the Commission's public comments on the matter have been limited, in granting no action relief in two of the three proxy cases, the Commission noted “that there appears to be some basis for your view that implementation of the proposal would cause the company to violate the federal securities laws.”

In light of the recent pressure from certain interest groups to overturn that policy, however, it appears likely that the Commission could be forced to address the issue again in the near future, whether through an IPO filing, a proxy proposal, or some other means. Regardless of how the issue arises, the Commission should assert its authority to prohibit the use of mandatory shareholder arbitration clauses.

Mandatory Shareholder Arbitration is Contrary to the Law

The SEC's long-held view that mandatory shareholder arbitration would violate the federal securities laws is the correct one. Such clauses violate anti-waiver provisions of the federal securities laws, which clearly grant jurisdiction of private disputes to the courts. Moreover, corporate offering documents and bylaws are not contracts subject to the Federal Arbitration Act and, even if they

were, subsequent congressional actions preserving investors' right to participate in class actions would override the FAA. For all these reasons, the Commission cannot reasonably reverse its past position against mandatory shareholder arbitration.

- Both the Securities Act of 1933 and the Securities Exchange Act of 1934 include strong “anti-waiver” provisions, which expressly provide that “[a]ny condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision” or related rules or regulations “shall be void.” The Supreme Court has ruled that the Exchange Act’s anti-waiver language is violated if a provision “weakens [investors’] ability to recover under the Exchange Act.”
- The court has ruled, moreover, that a provision waiving a shareholder’s right to sue in court would violate section 29(a) “where arbitration is inadequate to protect the substantive rights at issue.” The SEC has generally held that, unlike mandatory arbitration clauses in investors’ brokerage account contracts, shareholder arbitration does not meet this test, in part because it would not be subject to the same degree of SEC oversight.
- Some advocates of mandatory shareholder arbitration point to the FAA as trumping the securities laws’ anti-waiver provisions. However, the FAA generally applies to provisions in contracts between parties, and to disputes arising out of those contracts. Corporate organizational documents and bylaws do not constitute a contractual relationship subject to the FAA, and the waiver of rights made unilaterally through a corporate charter or other corporate document is fundamentally different than one made as a result of entering into a contract.
- Even if a court were to conclude that a company’s bylaws and organizational documents somehow constituted a contract that falls within the FAA’s reach, the fact remains that the FAA’s mandate has been overridden by a contrary congressional command. The FAA predates the federal securities laws, in which Congress expressly included the right to sue, conferred appropriate jurisdiction onto the courts, and included strong anti-waiver language. More recently, both the Private Securities Litigation Reform Act of 1995 and Securities Litigation Uniform Standards Act of 1998 expressly discussed the methods, standards, and procedures for private legal action. Far from permitting mandatory shareholder arbitration, in both instances Congress clearly expressed its intent that the right to bring class actions should be preserved and that, when litigated, such actions should be litigated in federal court.

Congress could, at any time, have taken action to permit mandatory shareholder arbitration, but it has not. Instead, even as it was acting to limit “frivolous” securities class action lawsuits, it reiterated its view that meritorious private lawsuits serve a necessary and positive public purpose.

Mandatory Shareholder Arbitration is Contrary to Public Policy

As the courts, Congress, and the SEC have all acknowledged, the integrity of our financial markets depends upon investors' having access to the courts to resolve claims under the federal securities laws. This is necessary both to provide defrauded investors with an opportunity to recover their losses and to provide an essential supplement to the SEC's enforcement activities as a deterrent to fraud. As the SEC has long acknowledged, it cannot fulfill these functions on its own. Not just investors, but also issuers, benefit in the form of higher valuations and lower cost of capital that result from these rigorous enforcement mechanisms.

Mandatory shareholder arbitration would seriously undermine the deterrent effect of private class action lawsuits by:

- **Making it uneconomical to bring meritorious claims.** The complex frauds that are often the subject of shareholder class actions are costly to prosecute, involving out-of-pocket expenses for experts and other litigation costs that can easily amount to more than a million dollars. Without the ability to participate in class actions, only the largest institutional investors would have claims of sufficient size to support the litigation costs. Smaller investors would be shut out.
- **Reducing settlement amounts.** Private class action lawsuits typically settle for significantly larger amounts than the SEC recovers. By eliminating the threat of large private settlements, mandatory shareholder arbitration would also eliminate an important deterrent to fraud and misconduct.
- **Eliminating an important tool for identifying misconduct.** Private lawsuits have played an important role in identifying misconduct that might otherwise go undetected by the SEC. Indeed, academic research indicates that private lawsuits more accurately identify and target misconduct than SEC enforcement.
- **Frustrating the development, clarification, and publication of the law.** Because of arbitration's often confidential nature, the absence of any requirement for arbitrators to follow the law, and the extremely limited opportunity for judicial review, mandatory shareholder arbitration would provide almost none of the public record of facts and precedential value of lawsuits. The publication of legal opinions resulting from litigation in court offers guidance to executives, lawyers, businesses, and transaction planners on how to comply with the federal securities laws and, as a result, helps to deter future misconduct by providing public notice of permissible and impermissible behavior.

For many of these same reasons, mandatory shareholder arbitration would also dramatically reduce defrauded investors' ability to recover their losses. If class actions were no longer available, SEC enforcement actions would constitute the

primary means of compensating defrauded investors. And, as noted above, these SEC actions typically result in dramatically less compensation to fraud victims than private class actions.

Smaller investors would be particularly hard hit, as they would rarely if ever have claims of sufficient size to support the costs of litigation. Because larger investors might still be incentivized and capable of bringing their claims, the system would essentially bifurcate, so that larger investors might recover for frauds while smaller investors would not. Worse, assuming that both large and small investors still owned the defendant companies (as is common), smaller investors who are victims of the same fraud, but unable to recover, could end up bearing the cost of compensating larger investors.

Mandatory shareholder arbitration would have a number of other harmful impacts. It would, for example:

- **Undermine the fair and consistent application of the law**, posing risks to investors and issuers alike. Investors could be harmed if meritorious claims are unfairly denied or inadequately compensated. But companies could also face the risk that meritless claims that could not meet PSLRA's heightened pleading standards were nonetheless permitted to move forward in arbitration. At the very least, it would be difficult to ascertain whether the law was being fairly applied, given the opacity of the arbitration process.
- **Deny the SEC the ability to assert its jurisdiction over the development of the law.** For decades, the SEC has weighed in with courts as amici to assert its views and interpretations with regard to legal issues that affect its regulatory and enforcement efforts and important policy formulation. This opportunity would not be available in arbitration, and the opportunity for the SEC to shape the interpretation of the securities laws in this way would be significantly diminished.
- **Undermine U.S. capital markets and our economic competitiveness.** Proponents of mandatory arbitration have argued that, while U.S. markets may attract investors, the threat of litigation drives away foreign listings. The opposite is true. As Ernst and Young reported in 2017, "Attracted to the stability and liquidity of US capital markets, foreign companies today overwhelmingly choose the US when they list outside of their home markets." This can be attributed to the lower cost of capital and higher valuations that companies enjoy as a direct result of the U.S. market's high level of public and private enforcement.

The policy arguments in favor of mandatory shareholder arbitration are as weak as the arguments against it are strong. Ignoring the merits of the cases in question, supporters of mandatory arbitration point instead to the amounts public companies are forced to pay out in damages, as if litigation, rather than the underlying fraud, were the primary problem that needs to be solved. In analyzing their arguments, it quickly becomes clear that their objective in

pressing for arbitration is not simply to shift the venue in which private claims are brought, but precisely to limit the number of, and recoveries for, meritorious claims by investors. Put another way, these commenters seem to be arguing for mandatory shareholder arbitration precisely because it would be inadequate to protect the substantive rights at issue.

Those who argue in support of mandatory arbitration also fail to consider a host of other issues that would arise for companies that adopt mandatory shareholder arbitration clauses if the Commission were to approve this policy change. To date, neither the Commission nor supporters of mandatory shareholder arbitration clauses have offered any detailed analyses of these issues, which include serious questions regarding how to deal with the material, non-public information that could arise in the context of confidential arbitration proceedings. The Commission cannot reasonably adopt such a sweeping change without first giving careful attention, not just to the legality of such clauses, but to all the many legal and policy issues that would arise if mandatory shareholder arbitration clauses were permitted.

For all of these reasons, the Commission should continue to maintain its long held position that mandatory shareholder arbitration is both illegal under the securities laws and not in the public interest.



Introduction

One of the signal achievements of the 20th Century was the restoration of trust and confidence in the U.S. securities markets after the cataclysmic events triggered by the 1929 stock market crash. Between September of 1929 and July of 1932, the value of all stocks listed on the New York Stock Exchange fell from nearly \$90 billion to just under \$16 billion—a decline of 83 %. The value of bonds listed on that exchange declined by 37 %, from \$49 billion to \$31 billion. Roughly half of the \$50 billion in new securities sold in the previous decade turned out to be nearly or totally valueless.¹ Devastating as those losses were, the damage to the overall economy was worse.

Although the ride has not always been smooth, the U.S. securities markets came back from that collapse stronger than ever, engines of a U.S. economy that is the largest and most vibrant in the world. That remarkable recovery is based on a principle that is elegant in its simplicity: that “all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it.”² We achieve this by requiring all public companies “to disclose meaningful financial and other information to the public,” in order to create “a common pool of knowledge” all investors can use to decide whether to buy, sell, or hold a particular security.³ As the Securities and Exchange Commission (SEC) explains on its website, “Only through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions.”⁴

To ensure that standard is met, it is not enough to require the disclosure. Those requirements must be effectively enforced. Only then will investors feel they can trust and rely on the information they receive, confident that effective measures are in place to detect and deter fraud and confident that, should fraud occur despite those preventive measures, they will have a reasonable means to recover their losses.

For decades, the United States has stood apart from the rest of the world for the strength of its public and private enforcement of the securities laws.⁵ While companies have sometimes chafed at the relative intensity of this enforcement, particularly with regard to the costs of private lawsuits, evidence suggests that they reap “extraordinary benefits” from the increased investor confidence that



“The ultimate goal of both SEC enforcement lawyers and plaintiffs’ attorneys is to uncover and sanction fraud.”⁹

¹ Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance*, Aspen Publishers, 3rd edition (June 26, 2003).

² U.S. Securities and Exchange Commission, About the SEC, What We Do, <https://www.sec.gov/Article/whatwedo.html>

³ *Id.*

⁴ *Id.*

⁵ See John C. Coffee, Jr., Law and the Market: The Impact of Enforcement, 156 U. Pa. L. Rev. 229 (2007), available at https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1218&context=penn_law_review.

results.⁶ This takes the form of a significant valuation premium associated with listing in U.S. markets and a significantly lower cost of capital relative to foreign markets.⁷ Maintaining this advantage is crucial to the success of U.S. markets and, through them, to the health of the American economy.

Despite boosts in spending over the years, particularly in the wake of an unusually severe market crisis or undetected fraud, resources for federal oversight of the markets have failed to keep pace with the astounding growth of those markets. Repeated efforts to create a reliable self-funding mechanism for the SEC in order to insulate the agency from the vagaries of congressional funding have proven futile. That has left private lawsuits, always an important supplement to SEC enforcement, increasingly vital to the deterrence of fraud and the maintenance of investor confidence.

In this context, suggestions that the SEC might begin to dismantle that system of private enforcement are particularly disturbing. Yet recent news reports suggest that some in the issuer and academic community have been pushing the Commission to do just that, and seem to have received a sympathetic ear from at least some at the Commission. As a result, it seems increasingly likely that issue will once again come before the Commission.

Any such plans to reverse the Commission's decades-old opposition to mandatory shareholder arbitration threaten to erode public confidence in the reliability of company disclosures, undermining one of the key advantages U.S. markets enjoy over foreign rivals. Proposals to do so by permitting public companies to include mandatory arbitration agreements in their bylaws or offering documents are not just contrary to public policy, they are also illegal under the securities laws.

Federal Securities Laws Grant Investors a Right to Recourse

If a publicly traded company lies about its financials or withholds vital information from the public, how can investors recover their losses? What types of deterrents keep companies from engaging in fraud? For over eighty years in the United States, these two questions have been answered in the same way: a combination of government enforcement and private legal actions.⁸

⁶ *Id.* at 235.

⁷ *Id.*

⁸ As two well-known advocates for mandatory shareholder arbitration have noted, "Securities class actions have two principal rationales: compensation and deterrence." Hal S. Scott and Leslie N. Silverman, *Stockholder Adoption of Mandatory Individual Arbitration for Stockholder Disputes*, 36 Harvard J. L. & Pub. Policy 1187, 1189 (2013).

Congress, the courts, and the SEC all recognize the “essential” and “necessary” role that private lawsuits play in deterring fraud and compensating defrauded investors.

- Even as Congress took steps in the mid-1990s to put limits on securities class action lawsuits, for example, it reaffirmed its belief that, “Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely on government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs.”¹⁰
- Similarly, the Supreme Court “has long recognized that meritorious private actions to enforce federal anti-fraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission (SEC).”¹¹ Courts have recognized, moreover, the crucial role that private class actions play in promoting investor confidence, finding that, “The securities statutes seek to maintain public confidence in the


⁹ Stephen J. Choi and A.C. Pritchard, SEC Investigations and Securities Class Actions: An Empirical Comparison, June 3, 2015, U of Michigan Law & Econ Research Paper No. 12-022; NYU Law and Economics Research Paper No. 12-38., available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2109739.

¹⁰ See, e.g., H.R. Conf. Rept. No. 104-369, pg. 31 (1995), available at <https://www.congress.gov/104/crpt/hrpt369/CRPT-104hrpt369.pdf>. See also Prepared Statement of Sen. Richard Shelby (“Private actions under section 10(b) of the Securities Exchange Act serve two important purposes. These actions are the primary means through which defrauded investors can seek redress. The threat of a suit discourages would-be violators from committing fraud”); Prepared Statement of Sen. Pete V. Domenici (“I support a vigorous 10(b)(5) private right of action so that shareholders who are defrauded can be made as whole as possible. Perpetrators of fraud who compromise our capital markets for their own personal gain should pay a stiff penalty.”), Private Litigation Under the Federal Securities Laws, Hearings Before the Subcomm. on Sec. of the S. Comm. on Banking, Housing, & Urban Affairs, 103d Cong. 113 (1993), available at <https://archive.org/stream/privatelitigatio00unit/djvu.txt>.

¹¹ See, e.g., *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 308 (2007); see also *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (securities-fraud actions “are ‘a necessary supplement to [SEC] action.’”); accord *J.I. Case Co. v. Borak*, 377 U.S. 426, at 432 (1964); *Amgen Inc. v. CT Ret. Plans & Trust Funds*, 568 U.S. ___ (2013) (“We have already noted what Congress has done to control exorbitant securities-fraud actions. See supra, at 19–20. Congress, the Executive Branch, and this Court, moreover, have ‘recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission.’ *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U. S. 308, 313 (2007)”).

¹² *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 345 (2005).

¹³ See, e.g., Remarks by Commissioner Richard B. Smith, “The Interest of the Securities and Exchange Commission in Private Actions under the Securities Acts,” January 12, 1968, <https://www.sec.gov/news/speech/1968/011268smith.pdf> (“After all, the Commission is in the business of protecting investors, and no system of protection would be complete unless it provided some reasonably usable means for injured investors to obtain monetary redress in cases in which our own enforcement activities did not prevent the injury.”) (Smith also referenced a Commission amicus brief, in which the SEC argued that “the class action procedure is particularly appropriate where a large number of persons are alleged to have suffered a common wrong and their individual injuries may be small — a situation which typically arises where there has been a widespread securities fraud or manipulation of the securities markets.”); Private Litigation Under the Federal Securities Laws, Hearings Before the Subcomm. on Sec. of the S. Comm. on Banking, Housing, & Urban Affairs, 103d Cong. 113 (1993) (statement of William R. McClucas, Director, Division of Enforcement, SEC) (“Given the continued growth in the size and complexity of our securities markets, and the absolute certainty that persons seeking to perpetrate financial fraud will always be among us, private actions will continue to be essential to the maintenance of investor protection.”); Arthur Levitt, Chairman, Sec. & Exch. Comm’n, Remarks at the 22d Annual Securities Regulation Institute: Between Caveat Emptor and Caveat Venditor: The Middle Ground of Litigation Reform (Jan. 25, 1995), available at <http://www.sec.gov/news/speech/speecharchive/1995/spch023.txt> (“[T]he longtime SEC belief [is] that private rights of action are not only fundamental to the success of our securities markets, they are an essential complement to the SEC’s own enforcement program.”); Statement by Commissioner: Investors Deserve their Day in Court, Commissioner Luis A. Aguilar, April 11, 2012, <https://www.sec.gov/news/public-statement/2012-spch041112laahmt> (“it is clear that investors must have private rights of action co-extensive with the Commission’s under Section 10(b). It is unrealistic to expect that the Commission will have the resources to police all securities frauds on its own, and as a result, it is essential that investors be given private rights of action to complement and complete the Commission’s efforts.”); Thomas L. Riesenber, SEC, Commentary, Arbitration and Corporate Governance: A Reply to Carly Schneider, *Insights*, Vol. 4, No. 8, at 2, August 1990 (“it would be contrary to the public interest to require investors who want to participate in the nation’s equity markets to waive access to a judicial forum for vindication of federal or state law rights, where such waiver is made through a corporate charter rather than an individual investor’s decision”).



“Private suits under Section 10(b) of the Securities Exchange Act and Rule 10(b)(5) thereunder ... are instrumental in recompensing investors who are cheated through the issuance of false and misleading information or by other means. When corporate officers, accountants, lawyers or others involved in the operation of a public company deceive investors for their own benefit, they should be held accountable for their actions. If this were not the case, investors would be far less willing to participate in our securities markets. This would limit the most important source, and raise the costs, of new capital for all American businesses.”¹⁷


**Former SEC Chairman
Richard Breeden**

marketplace . . . by deterring fraud, in part, through the availability of private securities fraud actions.”¹²

- The SEC as an institution and individual Commissioners from both political parties have over the years repeatedly affirmed the importance of private lawsuits as a complement to agency actions.¹³ An amicus brief filed jointly by the SEC and the Department of Justice (DOJ) stated, for example, that, “Meritorious private securities-fraud actions, including class actions, are an essential supplement to criminal prosecutions and SEC enforcement actions.”¹⁴ Two former chairmen — Democrat Arthur Levitt and Republican William Donaldson — along with former Commissioner Harvey Goldschmid, affirmed the importance of private litigation in a joint amicus brief, stating, “Private actions are the principal means by which defrauded investors recover their losses due to the Commission’s limited resources and powers.”¹⁵ Chairman Levitt separately noted that this “is not just a question of investor interests — it is a question of the market’s interests. Private securities litigation plays a prominent role in checking market excesses. To change that, we’d need to recalibrate our entire system of checks and balances.”¹⁶

This role is firmly ensconced in the law.

Section 10(b) and Rule 10b-5 collectively prohibit making any material misstatement or omission in connection with the purchase or sale of any security. These provisions are relied upon by the government to bring criminal prosecution and civil enforcement proceedings against corporate issuers and executives who engage in securities fraud. In addition, while Section 10(b) does not create an express private cause of action, the Supreme Court has “long recognized an implied private cause of action to enforce the provision and its implementing regulation.” Far from being an ancillary remedy, the Supreme Court has declared that “private actions to enforce federal antifraud securities laws are an essential supplement” to governmental actions.²¹ Dating back to the 1940s, the SEC actively encouraged court recognition of an implied right of



“It would be difficult, not to say unwise, to centralize all responsibility for the integrity of our markets in Washington. The Commission was not intended to be the KGB of Capitalism — we’re not equipped to operate as an all-pervasive agency. Instead, over the decades, a structure has been created in which, for the most part, market forces can solve market problems, and investors reserve the right to protect themselves. The securities laws are not a call for market participants to relinquish responsibility, but rather to take it.”¹⁸

**Former SEC Chairman
Arthur Levitt**

¹⁴ Brief for the United States as Amicus Curiae Supporting Respondent, *Amgen Inc. v. Connecticut Retirement Plans*, 568 U.S. __ (2013), available at https://www.americanbar.org/content/dam/aba/publications/supreme_court_preview/briefs/11-1085_respondentamcuusa.authcheckdam.pdf

¹⁵ Brief Amici Curiae of Former SEC Commissioners in Support of Petitioner Interest, *Stoneridge Investment Partners, LLC v. Scientific-Atlantic, Inc.*, 552 U.S. 148 (2008), available at <http://www.findlawimages.com/efile/supreme/briefs/06-43/06-43.mer.ami.sec.pdf> (“Private cases, so long as they are well-grounded, are an important enforcement mechanism supplementing the SEC in the policing of our markets. Most often, the larger the frauds, the greater investors must rely on private cases to recover their losses.”)

¹⁶ *Between Caveat Emptor and Caveat Venditor: The Middle Ground of Litigation Reform* (Jan. 25, 1995).

¹⁷ Prepared Statement of Richard C. Breeden, Chairman, Securities and Exchange Commission, to Senator Domenici, August 12, 1992, *Private Litigation Under the Federal Securities Laws*, Hearings Before the Subcomm. on Sec. of the S. Comm. on Banking, Housing, & Urban Affairs, 103d Cong. 113 (1993).

¹⁸ *Between Caveat Emptor and Caveat Venditor: The Middle Ground of Litigation Reform* (Jan. 25, 1995).

¹⁹ Securities Exchange Act of 1934, 48 Stat. 891, 15 U.S.C. § 78j(b), and Securities and Exchange Commission Rule 10b-5, 17 CFR § 240.10b-5 (2013).

²⁰ *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2407 (2014) (citing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730, 95 S.Ct. 1917 (1975)).

²¹ *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 308 (2007).

action, specifically pointing to the role private actions played in supplementing Commission enforcement.²²

That doesn't mean, of course, that the right of private redress for federal securities violations is unfettered. To the contrary, Congress and the courts have expressly sought to curb "abusive and meritless" litigation, including through the passage of the Private Securities Litigation Reform Act of 1995 (PSLRA)²³ and Securities Litigation Uniform Standards Act of 1998 (SLUSA).²⁴ But even then, while raising the bar for securities class action lawsuits, Congress was careful to protect investors' fundamental right to recourse through meritorious private litigation.²⁵

In contrast, proposals to permit public companies to adopt forced arbitration provisions would eliminate this "indispensable tool," threatening not only the ability of defrauded investors to recover their losses, but also the "public and global confidence in our capital markets"²⁶ that is a direct benefit of their deterrent effect. To be clear, at the time that Congress was making the changes adopted in PSLRA and SLUSA, or at any other time since these issues were raised, it could have expressly reversed its position — and the SEC's longstanding policy — to permit mandatory shareholder arbitration. It did not.

A policy change of this magnitude — one that flies in the face of decades of congressional, court, and SEC precedent — can only properly be addressed by Congress, which has refused time and again to abrogate investors' rights in this way.

Arbitration Has Become a Common Dispute Resolution Technique

While Congress and the SEC have taken a dim view of mandatory shareholder arbitration, that does not mean that arbitration, as a dispute resolution technique, is disfavored. Quite the opposite. Since the adoption of the United States Arbitration Act (commonly called the "Federal Arbitration Act" or "FAA") in 1925,²⁷ arbitration has become an increasingly common tool to resolve commercial disputes. In relevant part, the FAA provides that:

²² Elisse Walter, Remarks Before the FINRA Institute at Wharton Certified Regulatory and Compliance Professional (CRCP) Program, Aug. 11, 2011, available at <https://www.sec.gov/news/speech/2011/spch110811ebw.htm>.

²³ Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified at 15 U.S.C. §§ 78(a) et seq.)

²⁴ Pub. L. No. 105-353, 112 Stat. 3227 (1998).

²⁵ See, e.g., Joint Explanatory Statement of the Committee of Conference on H.R. 1058, 31, reprinted in 2 U.S.C.A.N. 730 (104th Cong., 1st Sess. 1995)(report to the Private Securities Litigation Reform Act of 1995, which sought to reduce perceived "meritless" suits through procedural and other means).

²⁶ *Id.*

²⁷ Pub.L. 68-401, 43 Stat. 883 (1925) (codified at 9 U.S.C. §1 et seq.).

A written provision in any maritime transaction or 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.²⁸

Courts must “rigorously enforce agreements to arbitrate,”²⁹ including for “claims that allege a violation of a federal statute, unless the FAA’s mandate has been ‘overridden by a contrary congressional command.’”³⁰ Further, parties may be compelled to individually arbitrate their contractual disputes, even though the cost of appropriately pursuing an individual claim might significantly exceed any potential recovery.³¹

On the other hand, the Supreme Court will invalidate arbitration agreements where the agreement precludes the effective vindication of a statutory right.³² That does not mean, however, that the process for vindicating those rights will necessarily be as robust or structured as it would be in court. As the Supreme Court itself has recognized:

For the individual, whether his case is settled by a professional arbitrator or tried by a jury can make a crucial difference. Arbitration differs from judicial proceedings in many ways: arbitration carries no right to a jury trial as guaranteed by the Seventh Amendment; arbitrators need not be instructed in the law; they are not bound by rules of evidence; they need not give reasons for their awards; witnesses need not be sworn; the record of proceedings need not be complete; and judicial review, it has been held, is extremely limited.³³

In light of the deference the court gives to arbitration agreements, it is not surprising that over the past few years alone, courts have compelled parties to rely upon their arbitration agreements in a wide array of commercial matters.

Those who favor the resolution of commercial disputes through arbitration typically cite its perceived benefits. These include:

- The parties’ ability to set their own procedural rules for resolving the dispute;
- The typically accelerated pace of proceedings;
- The often lower expenses;

²⁸ 9 U. S. C. §2.

²⁹ *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 226 (1987) (quoting *Dean Witter Reynolds v. Byrd*, 470 U.S. 213, 221 (1985)).

³⁰ *American Express Company, et al, v. Italian Colors Restaurant et al*, 133 S. Ct. 2304 (2013) (citing *CompuCredit Corp. v. Greenwood*, 565 U. S. ___, ___ (2012) (slip op., at 2–3) (quoting *Shearson/American Express Inc. v. McMahon*, 482 U. S. 220, 226 (1987))).

³¹ *American Express Company, et al, v. Italian Colors Restaurant et al*, 133 S. Ct. 2304, 2309 (2013).

³² See *American Express Company, et al, v. Italian Colors Restaurant et al*, 133 S. Ct. 2304, 2312 (2013).

³³ *Republic Steel Corp. v. Maddox*, 379 U.S. 650, 664 (1965).

- The greater flexibility in the process than in court proceedings, including more limited discovery; and
- Confidentiality.³⁴

Despite these perceived benefits, arbitration is also replete with well-established limitations and flaws. Among the most serious:

- Arbitrations may preclude class actions, eliminating the only realistic avenue for bringing both small claims and claims involving complex frauds;
- Arbitration may limit available remedies, such as precluding additional penalties that would otherwise be permitted by law;
- Arbitrators are often not required to follow the law, or even their own rules, undermining assurances that the law will be fairly and consistently applied;
- The right to appeal erroneous rulings is typically limited;
- Arbitrators and arbitration providers may be incentivized to favor corporate defendants;
- Arbitrations may make it difficult for potential plaintiffs to obtain and retain quality legal counsel and experts; and
- Arbitrations may be more expensive and inconvenient for potential plaintiffs to pursue, such as by requiring travel expenses and costs be borne by the party asserting the claim.³⁵

Arbitrated resolutions may also provide limited precedential value and public accountability for wrongdoing, which is further exacerbated if the arbitrations are kept confidential. Core components of securities law have been shaped through judicial decisions in private litigation, including the definition of “security,” when fraud is “in connection with” securities purchases or sales, and the degree of intent needed to violate the securities laws, among others.³⁶ Those critical developments would be severely curtailed, if not lost entirely, if arbitration replaced litigation as the primary method of private enforcement.

Limits on discovery, touted as a benefit of arbitration, could have a similarly negative effect, by making it all but impossible to successfully prosecute a complex fraud in an arbitration proceeding. In short, even some of the perceived advantages of the dispute resolution process may give rise to suboptimal outcomes, potentially leaving aggrieved parties without adequate redress.

³⁴ See generally, American Bar Association, Section on Dispute Resolution, *Benefits of Arbitration for Commercial Disputes*, Mar. 2012, available at https://www.americanbar.org/content/dam/aba/publications/dispute_resolution_magazine/March_2012_Sussman_Wilkinson_March_5.authcheckdam.pdf.

³⁵ See generally Taylor Lincoln and David Arkush, Public Citizen, *The Arbitration Debate Trap*, 2008, available at <https://www.citizen.org/sites/default/files/arbitrationdebatefinal.pdf>.

³⁶ Elisse Walter, Remarks Before the FINRA Institute at Wharton Certified Regulatory and Compliance Professional (CRCP) Program, Aug. 11, 2011, available at <https://www.sec.gov/news/speech/2011/spch110811ebw.htm>.

Numerous studies have found that the results of arbitrations are often skewed heavily in favor of businesses defending claims, as opposed to the consumers or employees who bring them.³⁷ And the contrast in outcomes between mandatory arbitrations and class actions is often stark. For example, one study into consumer financial arbitrations (as distinct from FINRA arbitrations) found that, in an average year, “[a]t least 6,800,000 consumers get cash relief in class actions—compared with just 16 consumers who receive cash relief in arbitration.”³⁸ Moreover, because of the way costs are allocated in arbitration, the average consumer who arbitrates a claim against a bank or lender ends up paying \$7,725.³⁹

Nevertheless, arbitration agreements are contracts, and will generally be enforced as such.

The SEC Has Rejected Past Attempts by Public Issuers of Securities to Require Mandatory Shareholder Arbitration

To date, shareholders of public companies have largely escaped the harmful impact of mandatory arbitration provisions. That is because, for decades, the SEC has refused to permit companies with publicly traded securities in the United States to include mandatory shareholder arbitration clauses in their bylaws or other organizational documents. That said, the SEC’s resolve has been tested several times and is currently facing yet another looming challenge.⁴⁰

³⁷ See *Lincoln and Arkush, Public Citizen, The Arbitration Debate Trap*; See also Heidi Shierholz, Economic Policy Institute, *Correcting the record: Consumers fare better under class actions than arbitration*, Aug. 1, 2017, available at <https://www.epi.org/publication/correcting-the-record-consumers-fare-better-under-class-actions-than-arbitration/>.

³⁸ Shierholz, *Economic Policy Institute, Correcting the record: Consumers fare better under class actions than arbitration* (citing Consumer Financial Protection Bureau, *Arbitration Study Report to Congress, pursuant to Dodd-Frank Wall Street Reform and Consumer Protection Act § 1028(a)*, Mar. 2015, available at https://files.consumerfinance.gov/f/201503_cfpb_arbitration-study-report-to-congress-2015.pdf).

³⁹ Shierholz, *Correcting the record*.

⁴⁰ See Benjamin Bain, *SEC Weighs a Big Gift to Companies: Blocking Investor Lawsuits*, BLOOMBERG, Jan. 26, 2018, available at <https://www.bloomberg.com/news/articles/2018-01-26/trump-s-sec-mulls-big-gift-to-companies-blocking-investor-suits>. See also Patrick Temple-West, POLITICO Pro Q&A: SEC Commissioner Hester Peirce, Aug. 2, 2018 (“I absolutely think mandatory arbitration should be an option for companies, and if companies and their shareholders decide that’s what is appropriate for them I think we shouldn’t stand in the way of it.”).

⁴¹ This appears to have followed shortly after, and perhaps was spurred on by, a Supreme Court decision in 1987 to uphold the arbitration process used to settle customer disputes with their brokers. *Shearson/American Exp., Inc. v. McMahon*, 482 U.S. 220 (1987). Interestingly, the company which was identified as being involved was said to have gone public in 1988. See *SEC News Digest, SEC*, at 4, August 25, 1998, available at <https://www.sec.gov/news/digest/1988/dig082588.pdf>. However, contemporaneous accounts suggest that the company went public in 1990. See Carl W. Schneider, *Arbitration in Corporate Governance Documents: An Idea the SEC Refuses to Accelerate*, Insights, Vol. 4, No. 5, at 27, Note 10 (“For reasons unrelated to arbitration, the company’s offering was delayed. It has not yet filed an acceleration request, and its registration statement has not yet become effective.”)

SEC Has Refused to Accelerate IPO Filings for Companies Seeking to Include Mandatory Arbitration Clauses

What appears to be the first relatively modern test of the SEC's resolve in prohibiting mandatory shareholder arbitration arose in 1988,⁴¹ when Franklin First Financial Corp. reportedly declared its intention to include mandatory shareholder arbitration in its charter and bylaws in advance of its planned initial public offering.⁴² The company, which was then represented by a former SEC lawyer, Carl W. Schneider,⁴³ argued that disclosure of its shareholder arbitration mandate in its articles was adequate because it allowed investors in the forthcoming IPO to make the determination regarding whether they were willing to accept the more limited set of remedies.

The SEC clearly and unambiguously rejected that view. As Mr. Schneider himself later recounted to the American Bar Association:

After the filing, **the commission itself, as well as the staff, expressed horror at the concept of a mandatory arbitration provision in our company's articles.** Shortly after the initial filing, I was advised that the commission itself determined not to allow acceleration of the registration's statement's effectiveness if and when we requested acceleration — a preemptive strike, because acceleration had not yet been requested — unless we eliminated the arbitration provision.⁴⁴

The company withdrew the arbitration provision from its articles of incorporation and proceeded with the offering.⁴⁵ Clearly, the restriction on the company's use of an arbitration clause did not deter the company from going public.

More than two decades later, on January 10, 2012, the issue came to the front burner again, as The Carlyle Group LP (Carlyle) filed a revised draft registration statement with the SEC that would have required investors to individually arbitrate disputes.⁴⁶ The revised filing contained several pages

⁴² While the documents related to the company's filing do not appear to reflect this debate over the mandatory shareholder arbitration issue, the back-and-forth with the agency was reflected in detail in 1990 by the company's outside legal counsel, Carl Schneider. Carl Schneider, *Change, the SEC and ...me: Reflections from the Loyal Opposition*, Revised remarks before the 1998 ABA Annual Meeting, at 14, available at http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1990/1999_0506_Schneider_Change.pdf.

⁴³ Carl Schneider, *Change, the SEC and ...me: Reflections from the Loyal Opposition*, Revised remarks before the 1998 ABA Annual Meeting, at 3, available at http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1990/1999_0506_Schneider_Change.pdf ("The one project on which I have — to date — suffered a complete defeat was my effort to include an arbitration provision in a corporate-governance document. That was my only battle with the SEC undertaken on behalf of a specific client.").

⁴⁴ Carl Schneider, *Change, the SEC and ...me: Reflections from the Loyal Opposition*, Revised remarks before the 1998 ABA Annual Meeting, at 14, available at http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1990/1999_0506_Schneider_Change.pdf (emphasis added).

⁴⁵ Franklin First Financial Corp. filed a S-1 in May 1988, and it went effective on July 8, 1988. See *SEC News Digest*, SEC, at 4, August 25, 1988, available at <https://www.sec.gov/news/digest/1988/dig082588.pdf>. See also Carl Schneider, *Change, the SEC and ...me: Reflections from the Loyal Opposition*, Revised remarks before the 1998 ABA Annual Meeting, at 15, available at http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1990/1999_0506_Schneider_Change.pdf.

⁴⁶ S-1/A, The Carlyle Group L.P., Jan. 10, 2012, available at <https://www.sec.gov/Archives/edgar/data/1527166/000095012312000638/w83442a2sv1za.htm>. Notably, the originally filed draft S-1 did not contain any such mandatory arbitration provisions. See S-1, The Carlyle Group L.P., Sept. 6 2011, available at <https://www.sec.gov/Archives/edgar/data/1527166/000095012311082561/w83442sv1.htm>.

detailing exactly how participating purchasers could be compelled to individually arbitrate individual claims.⁴⁷ Like other advocates of mandatory arbitration (see above), the company argued that arbitrating claims would be more efficient, cost effective and beneficial for its investors.⁴⁸

The pushback was nearly immediate. Institutional investors and their advocates expressed their displeasure to the company, the SEC, and members of Congress. The SEC staff informed Carlyle that it would not accelerate the effective date of Carlyle's registration statement if the statement included the mandatory shareholder arbitration provision, meaning that the Commission would need to make any decision itself. And three U.S. Senators sent a letter to then-SEC Chair Mary Schapiro urging the SEC "to deny the acceleration of registration statements that would unlawfully deprive investors of their ability to vindicate their statutory rights through the inclusion of provisions requiring individual, confidential arbitration of all shareholder disputes."⁵⁰

On February 3rd, "after consultations with the SEC, Carlyle investors and other interested parties,"⁵¹ Carlyle announced that it would reverse course.⁵² The SEC spokesman expressed that the agency was "pleased" with the company's decision.⁵³ Carlyle amended its filings,⁵⁴ and after a few more revisions, the company completed its IPO in early May 2012 without the mandatory arbitration clause.⁵⁵

⁴⁷ See, e.g., S-1/A, The Carlyle Group L.P., Jan. 10, 2012, at 16, 66-67, 287-289, available at <https://www.sec.gov/Archives/edgar/data/1527166/000095012312000638/w83442a2sv1za.htm>.

⁴⁸ Miles Weiss, Jesse Hamilton, and Cristina Alesci, *Carlyle Drops Class-Action Lawsuit Ban as Opposition Mounts*, Bloomberg, Feb. 3, 2012, available at <https://www.bloomberg.com/news/articles/2012-02-03/carlyle-drops-class-action-lawsuit-ban> (quoting a statement provided by Carlyle spokesman Chris Ullman). Interestingly, the SEC has previously asserted nearly the opposite. Order Approving Proposed Rule Change Relating to the Exclusion of Class Actions from Arbitration Proceedings, 57 Fed. Reg. 52659, 52660 (Nov. 4, 1992) ("Without access [to] class actions in [appropriate] cases, both investors and broker-dealers have been put to the expense of wasteful, duplicative litigation....The Commission believes that investor access to the courts should be preserved for class actions.").

⁴⁹ See Letter from Pamela Long, SEC, to Jeffrey W. Ferguson, The Carlyle Group L.P., at 1, Feb. 3, 2012, available at <https://www.sec.gov/Archives/edgar/data/1527166/000000000012006433/filename1.pdf> (recapping a telephone call between SEC staff and Carlyle legal counsel).

⁵⁰ Letter from Senator Al Franken, Senator Richard Blumenthal, and Senator Robert Menendez, to Mary Schapiro, SEC, Feb. 3, 2012, available at <https://www.scribd.com/doc/80406909/Senate-Letter-on-Carlyle-I-P-O-Provisions#download>.

⁵¹ Miles Weiss, Jesse Hamilton, and Cristina Alesci, *Carlyle Drops Class-Action Lawsuit Ban as Opposition Mounts*, Bloomberg, Feb. 3, 2012, available at <https://www.bloomberg.com/news/articles/2012-02-03/carlyle-drops-class-action-lawsuit-ban> (quoting a statement provided by Carlyle spokesman Chris Ullman). During those consultations, the SEC staff "advised counsel that the Division of Corporation Finance does not anticipate that it will exercise its delegated authority to accelerate the effective date of your registration statement if your limited partnership agreement includes such a provision." Thus, the acceleration would be sent to the full Commission for consideration. Letter from Pamela Long, SEC, to Jeffrey W. Ferguson, The Carlyle Group L.P., at 1, Feb. 3, 2012, available at <https://www.sec.gov/Archives/edgar/data/1527166/0000000000012006433/filename1.pdf>.

⁵² Miles Weiss, Jesse Hamilton, and Cristina Alesci, *Carlyle Drops Class-Action Lawsuit Ban as Opposition Mounts*.

⁵³ *Id.*

⁵⁴ S-1/A, The Carlyle Group L.P., Feb. 14, 2012, available at <https://www.sec.gov/Archives/edgar/data/1527166/000095012312002453/w83442a3sv1za.htm>.

⁵⁵ Michael J. De La Merced, *Carlyle Prices I.P.O. at \$22, Below Expected Level*, May 2, 2012, available at <https://dealbook.nytimes.com/2012/05/02/carlyle-prices-its-i-p-o-at-22/>.

SEC Has Backed Companies Seeking to Exclude Mandatory Arbitration Proxy Proposals

IPO filings are not the only avenue for adopting mandatory arbitration provisions.⁵⁶ In at least three instances, shareholders have unsuccessfully pressed already public companies to change their bylaws to provide for mandatory shareholder arbitration.

The earliest instance we were able to locate involved Alaska Air Group, Inc. (Alaska Air). On November 28, 2008, shareholders requested a package of proxy proposals, including one that would have recommended that the company's board adopt sweeping language in the company's bylaws requiring disputes to be resolved through arbitration.

Alaska Air notified the SEC and asked for no-action relief to support its decision to exclude the proposal from its proxy materials.⁵⁷ Among other arguments, the company justified the exclusion on the grounds that, if adopted, it would force the company to violate federal law.⁵⁸ The SEC ultimately granted the no-action relief, while not directly addressing the merits of the assertion.⁵⁹

A few years later, during the 2011-2012 proxy season, shareholders at two other companies, Gannett Co., Inc (Gannett)⁶⁰ and Pfizer Inc. (Pfizer),⁶¹ sought to change the bylaws of these already-public companies to provide for mandatory shareholder arbitration. As with Alaska Air before them, each of the companies resisted the proposals, arguing that they would force the company to violate federal law.⁶²

Just a few weeks after the SEC staff stated that it would not accelerate the effectiveness of Carlyle's registration statement, the SEC staff granted both

⁵⁶ See generally Carl Schneider, *Change, the SEC and ...me: Reflections from the Loyal Opposition*, Revised remarks before the 1998 ABA Annual Meeting, at 15, available at http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1990/1999_0506_Schneider_Change.pdf ("Presumably such a provision could be adopted by an amendment that the shareholders would approve. In the context of a proxy solicitation, the SEC has less leverage to frustrate the issuer's desire than it has in the context of a '33 Act filing requiring acceleration. It is also possible that a company would adopt a bylaw dealing with arbitration by action of its board, which typically has the power to amend the bylaws, without shareholder action."). As we discuss in greater detail below, in addition to these methods, a private company could also presumably become a public reporting company by triggering the size and ownership thresholds.

⁵⁷ Letter from Martin P. Dunn, Counsel for Alaska Air, to Office of Chief Counsel, Division of Corp. Finance, SEC, Jan. 23, 2009, available at <https://www.sec.gov/Archives/edgar/vpr/0903/09038703.pdf>.

⁵⁸ *Id.*

⁵⁹ Letter from Carmen Moncada-Terry, SEC, to Alaska Air Group, Inc., Mar. 5, 2009, available at <https://www.sec.gov/Archives/edgar/vpr/0903/09038703.pdf> (granting relief on the basis of that the proposal was included with others, thus violating the one proposal standard).

⁶⁰ Letter from Donald Vuchetich and Susan Vuchetich to Gannett Co. Inc., Nov. 11, 2011, available at <https://www.sec.gov/divisions/corpfm/cf-noaction/14a-8/2012/2donaldvuchetich022212-14a8.pdf>.

⁶¹ *Id.*

⁶² Letter from Kevin L. Vold, Counsel for Gannett, to Office of Chief Counsel, Division of Corp. Finance, SEC, at 2, Dec. 27, 2011, available at <https://www.sec.gov/divisions/corpfm/cf-noaction/14a-8/2012/2donaldvuchetich022212-14a8.pdf> (Adopting the bylaw change "would be contrary to the public policy interests underlying the federal securities laws and would cause the Company to violate Section 29(a) of the Exchange Act."); Letter from Matthew Lepore, Counsel for Pfizer, to Office of the Chief Counsel, Division of Corp. Finance, SEC, Dec. 20, 2012, available at <https://www.sec.gov/divisions/corpfm/cf-noaction/14a-8/2012/donaldvuchetich022212-14a8.pdf>; Letter from Matthew Lepore, Counsel for Pfizer, to Office of the Chief Counsel, Division of Corp. Finance, SEC, Jan. 12, 2012, available at <https://www.sec.gov/divisions/corpfm/cf-noaction/14a-8/2012/donaldvuchetich022212-14a8.pdf>.

Gannett's⁶³ and Pfizer's⁶⁴ no-action requests. In both instances, the SEC staff's decision was based on its conclusion "that there appears to be some basis for your view that implementation of the proposal would cause the company to violate the federal securities laws."⁶⁵

The well-publicized decision of the SEC in the Carlyle case, and the less-publicized decisions regarding Alaska Air, Gannett, and Pfizer, appear to have stemmed the tide of such requests. Since 2012, no operational company seeking to make a public offering has to our knowledge pressed the SEC to permit mandatory shareholder arbitration. Further, no operational company that has been already subject to Exchange Act reporting requirements or has been otherwise viewed as a "public" company has taken steps to include mandatory shareholder arbitration in its bylaws or other organizational documents.

We understand, however, that some companies using the Regulation A exemption from registration have conducted offerings that included mandatory shareholder arbitration clauses in their offering documents.⁶⁶ As Chairman Clayton has stated, "neither the federal securities laws nor the Commission's rules require the staff to make the same public interest determination [with regard to Reg A offerings] as is required when accelerating the effective date of a registration statement in the context of an IPO."⁶⁷ As a result, these offerings appear to have occurred without the Commission taking a position on the permissibility of the arbitration agreements.

Similarly, a handful of publicly-traded investment vehicles, known as Real Estate Investment Trusts (REITs), have adopted bylaws providing for mandatory shareholder arbitration. The first case appears to have involved Commonwealth REIT, which amended its bylaws to provide for mandatory arbitration after its public offering.⁶⁸ A small number of others have attempted this approach as well, although it is unclear how many.

In at least one such case, Select Income REIT was contacted by the SEC staff after the staff identified the bylaw change in its review of the company's 2013

⁶³ Letter from Mark Vilardo, Office of the Chief Counsel, Division of Corp. Finance, SEC, to Gannett Co., Inc., Feb. 22, 2012, available at <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2012/2donaldvuchetich022212-14a8.pdf>.

⁶⁴ Letter from Sirimal R. Mukerjee, Office of the Chief Counsel, Division of Corp. Finance, SEC, to Pfizer Inc., Feb. 22, 2012, available at <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2012/donaldvuchetich022212-14a8.pdf>.

⁶⁵ Letter from Mark Vilardo, Office of the Chief Counsel, Division of Corp. Finance, SEC, to Gannett Co., Inc., Feb. 22, 2012, available at <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2012/2donaldvuchetich022212-14a8.pdf>; see also Letter from Sirimal R. Mukerjee, Office of the Chief Counsel, Division of Corp. Finance, SEC, to Pfizer Inc., Feb. 22, 2012, available at <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2012/donaldvuchetich022212-14a8.pdf>.

⁶⁶ Letter from Chairman Jay Clayton, SEC, to Rep. Carolyn Maloney, Apr. 24, 2018, available at <https://maloney.house.gov/sites/maloney.house.gov/files/MALONEY%20ET%20AL%20-%20FORCED%20ARBITRATION%20-%20ES156546%20Response.pdf>.

⁶⁷ *Id.*

⁶⁸ See, e.g., *Corvex Mgmt. v. Commonwealth REIT*, 2013 Md. Cir. Ct. LEXIS 3 (Cir. Ct. Balt. May 8, 2013) (noting that Commonwealth REIT had amended its bylaws to provide for mandatory shareholder arbitration). Plaintiffs seeking to dispute a takeover action involving the issuer challenged the enforceability of that provision in state court. Although the court upheld the arbitration mandate with respect to state law actions, the court did not address whether the provision would apply to claims arising from violations of the federal securities laws. Rather, it was focused on state law claims arising from a disputed takeover action. However, for the reasons outlined below, we believe this state law action, was nevertheless wrongly decided.

Annual Report on Form 10-K. The SEC staff noted that “the bylaws were revised on February 21, 2013 to include a shareholder arbitration provision. Please provide us an analysis as to how this provision, when applied to claims related to the federal securities laws, is consistent with Section 14 of the Securities Act. The analysis should include a discussion of procedural protections, substantive remedies and Commission oversight.”⁶⁹ Select Income REIT responded by reversing course and agreeing to exclude disputes arising under the federal securities laws from the scope of its bylaw.⁷⁰

Meanwhile, amidst a handful of pro-arbitration Supreme Court rulings in recent years,⁷¹ some academics,⁷² corporate lawyers,⁷³ and even an SEC Commissioner,⁷⁴ have suggested that corporate issuers should continue to press for mandatory shareholder arbitration.

As discussed below, the question of whether to grant such requests may arise in a number of different contexts. Some may be within the control of the SEC, such as if the agency initiated notice-and-comment rulemaking, either at its own discretion or in response to a new Congressional direction.⁷⁵ However, this issue could also come before the SEC as a result of a company’s or a shareholder’s initiative. For example, mandatory shareholder arbitration provisions in corporate organizational documents could arise through a (welcome or hostile) proxy proposal, by a company direct listing, by a private company with a forced arbitration provision triggering the thresholds for becoming a reporting company, or even by an already public company simply changing its bylaws.

Regardless of how the issue arises, the Commission must assert its authority to prohibit the use of mandatory shareholder arbitration clauses as contrary to the federal securities laws and inconsistent with the public interest.

⁶⁹ Letter from John C. Popeo, Select Income REIT, to Jennifer Monick, SEC, Apr. 19, 2013, available at <https://perma.cc/68VJ-WLYM>.

⁷⁰ *Id.* (reflecting that the company would amend its bylaws further to “exclud[e] any Dispute that arises under the Federal securities laws and the rules and regulations of the S.E.C. in effect from time to time.”).

⁷¹ As alluded to earlier, it appears as though each time the Supreme Court rules in some manner to enforce a mandatory arbitration clause, of any variety and for any reason, some pro-arbitration advocates seem to quickly assert that such a decision is somehow dispositive in the context of corporate issuers of securities adopting mandatory shareholder arbitration. For example, the Franklin First Financial Corp filing followed Supreme Court’s decision to uphold arbitration agreements between customers and their brokers. *Shearson/American Exp., Inc. v. McMahon*, 482 U.S. 220 (1987). The Carlyle Group L.P. filing appears to have followed the Supreme Court’s decision to uphold arbitration agreements in consumer contracts. *AT&T Mobility v. Concepcion*, 563 U.S. 333 (2011). More recently, however, despite a sweeping decision by the Supreme Court to enforce arbitration provisions that bar class actions with respect to federal and claims, even if that means the costs of pursuing the claims greatly exceeds the potential recovery, no public issuer of securities has attempted to adopt mandatory shareholder arbitration. See *American Express Co. v. Italian Colors Restaurant*, 133 S. Ct. 2304 (2013).

⁷² See, e.g., Hal S. Scott and Leslie N. Silverman, *Stockholder Adoption of Mandatory Individual Arbitration for Stockholder Disputes*, 36 Harvard J. on Law and Pub. Policy 1187 (2013).

⁷³ See, e.g., Bradley J. Bondi, *Facilitating Economic Recovery and Sustainable Growth through Reform of the Securities Class-Action System: Exploring Arbitration as an Alternative to Litigation*, 33 Harvard J. L. & Pub. Policy 607 (2010).

⁷⁴ See Patrick Temple-West, POLITICO Pro Q&A: SEC Commissioner Hester Peirce, Aug. 2, 2018. See also Sarah N. Lynch, U.S. SEC’s Pivowar urges companies to pursue mandatory arbitration clauses, REUTERS, Jul. 17, 2017, available at <https://www.reuters.com/article/us-sec-arbitration/u-s-secs-pivowar-urges-companies-to-pursue-mandatory-arbitration-clauses-iduSKbn1A221y> (quoting Pivowar as stating, “For shareholder lawsuits, companies can come to us to ask for relief to put in mandatory arbitration into their charters. ... I would encourage companies to come and talk to us about that.”).

⁷⁵ In early 2018, multiple press reports suggested that the SEC had been reconsidering this issue, although SEC Chairman Clayton said that he was personally “not anxious” for the SEC to address this issue yet again. Hazel Bradford, SEC chairman says he is not ready to force arbitration, Pensions and Investments, Feb. 7, 2018, (citing to Chairman Jay Clayton’s response to a question from U.S. Senator Elizabeth Warren), available at <http://www.pionline.com/article/20180207/ONLINE/180209852/sec-chairman-says-hes-not-ready-to-force-arbitration>; See, e.g., Benjamin Bain, SEC Weighs a Big Gift to Companies: Blocking Investor Lawsuits, Bloomberg (Jan. 26, 2018), available at <https://www.bloomberg.com/news/articles/2018-01-26/trump-s-sec-mulls-big-gift-to-companies-blocking-investor-suits>.

Mandatory Shareholder Arbitration Is Contrary to the Law

Mandatory Shareholder Arbitration Violates the Anti-Waiver Provisions of the Securities Laws

The Securities Act of 1933 and the Securities Exchange Act of 1934 are each replete with examples where Congress directly conferred jurisdiction to the courts and authorized private suits to redress violations. Each act expressly refers to the jurisdiction of the “district court” to hear cases invoking rights created by the act (jurisdiction for private suits created by the Securities Act are “concurrent with State and Territorial courts”). Both laws also include strong “anti-waiver” provisions. Although not identical, these “anti-waiver” provisions expressly provide that “[a]ny condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision” of the Acts or related rules or regulations “shall be void.”⁷⁶

The Supreme Court has ruled that the Exchange Act’s anti-waiver language is violated if a provision “weakens [investors’] ability to recover under the Exchange Act.”⁷⁷ In fact, while simultaneously upholding arbitration agreement provisions in customers’ account contracts with their broker-dealers, the Court nevertheless ruled that a provision waiving a shareholder’s right to sue in court would violate section 29(a) “where arbitration is inadequate to protect the substantive rights at issue.”⁷⁸ For a variety of reasons discussed below, arbitration is inadequate to protect shareholders’ substantive rights under the securities laws, as the SEC and its staff have stated.⁷⁹

In fact, after the Supreme Court upheld arbitration in customer disputes involving broker-dealers and the SEC rebuffed Franklin First Financial Corp.’s attempt to go public with mandatory shareholder arbitration embedded in its organizational documents, the SEC’s then-Assistant General Counsel explained the Commission’s position.⁸⁰ That explanation distinguished arbitration of broker-customer disputes (which the SEC supported) from mandatory shareholder arbitration (which the SEC opposed) by noting that the SEC has extensive oversight of the former, but would not over the latter.⁸¹ In its amicus

⁷⁶ See Section 14 of the Securities Act and Section 29(a) of the Exchange Act.

⁷⁷ *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 230 (1987).

⁷⁸ *Id.*

⁷⁹ Brief for the SEC, at 20, *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987) (No. 86-44); Thomas L. Riesenber, Commentary, *Arbitration and Corporate Governance: A Reply to Carly Schneider*, Insights, Vol. 4, No. 8, at 2, August 1990 (“The Commission has long taken the view that including forced arbitration provisions in the corporate governance provisions of public companies violates section 29(a) of the Exchange Act because arbitration is inadequate to protect investors’ rights.”).

⁸⁰ Thomas L. Riesenber, SEC, *Arbitration and Corporate Governance: A Reply to Carl Schneider*, Insights, at 2, Aug. 1990.

⁸¹ *Id.* at 30 (“at least in part, because of the presence of Commission oversight of the arbitration process under Section 19 of the Exchange Act ... Because Commission oversight authority is lacking as to shareholder/issuer disputes, corporations may impose arbitration procedures that could be unfavorable to investors.”).

brief urging the Supreme Court to uphold an arbitration agreement between a broker and its customer, the SEC reinforced this point, stating that its argument “would not apply” where the arbitration procedure was not subject to the Commission’s Section 19 oversight for Self-Regulatory Organizations.⁸²

The Supreme Court appears to have agreed with the SEC that the SEC’s oversight of the broker-customer dispute resolution process was essential to ensuring that the rights of investors were protected.⁸³ Unfortunately for public companies seeking to adopt mandatory shareholder arbitration arising from provisions in bylaws or organizational documents, arbitration of such disputes would generally not be subject to extensive oversight and would thus be “inadequate to protect investors’ rights.”

This position also appears to be relatively well-settled law. In the more than eight decades of the federal securities laws, the SEC has never expressly permitted a public company to provide for mandatory shareholder arbitration, and only a handful of the thousands of public companies registered with the SEC over that time have ever raised the issue. Even then, three of those companies argued to the SEC that changing their bylaws to force mandatory shareholder arbitration would cause them to violate the anti-waiver provisions of federal securities laws.⁸⁴

The FAA Does Not Compel Enforcement of Mandatory Shareholder Arbitration

The Federal Arbitration Act applies to arbitration clauses “in any maritime transaction or contract evidencing a transaction involving commerce.”⁸⁵ Put another way, the FAA generally applies to provisions in contracts between parties, such as for the provision of goods or services.⁸⁶ As the Supreme Court has explained, “The FAA’s primary purpose [is to] ensur[e] that private

⁸² Brief for the SEC, at 20, *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987) (No. 86-44).

⁸³ Compare Brief for the Securities and Exchange Commission as Amicus Curiae Supporting Petitioners, *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220 (1987) (No. 86-44), 1986 WL 727882, at *13 (arguing that 1975 enhancements to Commission’s authority to regulate SRO arbitration renders it “adequate to enforce substantive duties under the securities laws”) with *McMahon* at 233 (stating, “Since the 1975 amendments to § 19 of the Exchange Act, however, the Commission has had expansive power to ensure the adequacy of the arbitration procedures employed by the SROs. No proposed rule change may take effect unless the SEC finds that the proposed rule is consistent with the requirements of the Exchange Act, 15 U.S.C. § 78s(b)(2); and the Commission has the power, on its own initiative, to “abrogate, add to, and delete from” any SRO rule if it finds such changes necessary or appropriate to further the objectives of the Act, 15 U.S.C. § 78s(c). In short, the Commission has broad authority to oversee and to regulate the rules adopted by the SROs 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.**”) (emphasis added).

⁸⁴ See, e.g., Letter from Kevin L. Vold, Counsel for Gannett, to Office of Chief Counsel, Division of Corp. Finance, SEC, at 2, Dec. 27, 2011, available at <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2012/2donaldvuchetich022212-14a8.pdf> (Adopting the bylaw change “would be contrary to the public policy interests underlying the federal securities laws and would cause the Company to violate Section 29(a) of the Exchange Act.”)

⁸⁵ 9 U. S. C. §2.

⁸⁶ See Jason M. Halper and William J. Foley, *Seven Months After "American Express v. Italian Colors Restaurant": The End Of Class Actions?*, 21 *Westlaw J.* 10 (Feb 2014) (“Nevertheless, AmEx and subsequent decisions reinforce that arbitration is a creature of contract.”), available at <http://www.mondaq.com/unitedstates/x/285906/Class+Actions/Seven+Months+After+American+Express+v+Italian+Colors+Restaurant+The+End+Of+Class+Actions>.

agreements to arbitrate are enforced according to their terms. Arbitration under the [FAA] is a matter of consent, not coercion...”⁸⁷

Thus, to find that the FAA applies to corporate organizational documents, as a matter of law, one would first need to conclude that the investor-corporate issuer relationship could be viewed as one between contracting counterparties.⁸⁸ Even Carl Schneider, the lawyer who first pressed this issue with the SEC more than fifty years after the adoption of the federal securities laws, implicitly recognized the need for an agreement to trigger the application of the FAA. He believed that a corporation’s governance documents, particularly if adopted before the IPO, could function as an agreement for this purpose.⁸⁹

Corporate Bylaws Are Not Agreements Subject to the FAA

In reality, however, changes to corporate bylaws or corporate organizational documents are simply not agreements subject to the protections of the FAA.⁹⁰ Several key elements of contract are missing, including, to varying degrees, privity and consent.⁹¹ As a review by more than two dozen of the top securities and corporate law professors in the country has explained:

[T]he FAA has never been interpreted to require the enforcement of bylaws or similar provisions unilaterally adopted to remove judicial oversight of investor disputes. ... [C]orporate bylaws – particularly in public corporations that form the basis of the nation’s financial markets – are vastly dissimilar to the kind of contractual agreements that have been enforced by courts, including the Supreme Court, under the FAA.⁹²

⁸⁷ *Volt Information Sciences v. Leland Stanford, Jr. University*, 489 U. S. 468, 487 (1989).

⁸⁸ Ann M. Lipton, *Manufactured Consent: The Problem of Arbitration Clauses in Corporate Charters and Bylaws*, 104 *Georgetown L. J.* 583, at 600 (2015), available at https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2572014.

⁸⁹ Carl W. Schneider, *Change, the SEC and...me: Reflections from the loyal opposition*, ABA Section of Business Law, *Business Law Today*, May/June 1999, available at <https://apps.americanbar.org/buslaw/blt/8-5sechange.html#arbitration> (“An appropriate provision in governance documents, especially one adopted pre-IPO before any public shareholders make their investments, would function as an agreement for this purpose.”).

⁹⁰ Ann M. Lipton, *Manufactured Consent: The Problem of Arbitration Clauses in Corporate Charters and Bylaws*, 104 *Georgetown L. J.* 583, at 600 (2015), available at https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2572014; Letter from James D. Cox, et. al, to Mary Jo White, Oct. 30, 2013, available at https://law.duke.edu/sites/default/files/centers/gfmc/session_2/4_letter_to_sec_re_arbitration_bylaws-10-30-2013.pdf; Myriam Gilles, *Opting Out of Liability: The Forthcoming, Near-Total Demise of the Modern Class Action*, 104 *Mich. L. Rev.* 3, at 423 (2005), available at <https://repository.law.umich.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1545&context=mlr>.

⁹¹ Randy E. Barnett, *A Consent Theory of Contract*, 86 *COLUM. L. REV.* 269, 270 (1986) (“Consent is the moral component that distinguishes valid from invalid transfers of alienable rights.”).

⁹² Letter from James D. Cox, et. al, to Mary Jo White, Oct. 30, 2013, available at https://law.duke.edu/sites/default/files/centers/gfmc/session_2/4_letter_to_sec_re_arbitration_bylaws-10-30-2013.pdf (signed by 29 of the leading securities and corporate law professors in the United States, including Professor James Cox (Duke University School of Law), Professor John Coates (Harvard Law School), Professor John C. Coffee, Jr. (Columbia Law School), J. Robert Brown, Jr. (University of Denver), Professor Donald C. Langevoort (Georgetown University Law Center), and Robert Jackson, Jr. (Columbia Law School) (the “Law Professors Letter”). But see *Corvex Mgmt. v. Commonwealth REIT*, 2013 Md. Cir. Ct. LEXIS 3 (Cir. Ct. Balt. May 8, 2013).

Another legal scholar put the issue succinctly:

There is simply no contractual relationship of any kind between the plaintiff and the defendant. The corporate issuer of securities contracts only with a syndicate of brokers, and even then only when it has a public offering. Remaining sales are transacted on a secondary market between strangers.⁹³

As a result, any attempt at asserting a “contractual relationship” between the issuer and investor would fail. Such an attempt would fail even more completely if the bylaws were to be amended after a company became public, or if the purchaser of the securities acquired them from a third party (such as on the open market, as opposed to from the company directly).

In his explanation of the SEC’s objection to mandatory shareholder arbitration in 1990, the then Assistant General Counsel explicitly explored whether there could be such a contractual relationship and concluded that “shareholders typically do not affirmatively agree to the provisions⁹⁴ in a corporate charter and generally have little knowledge of those provisions.” As a result, he concluded, “[a]bsent notice and consent, the arbitration agreement should be unenforceable.”⁹⁵

Furthermore, to the extent that organizational documents could potentially be viewed as binding on shareholders, such “contractual” relationship would be conscribed to “intra-corporate” litigation.⁹⁶ Further still, the FAA only applies to arbitration clauses contained in “contract[s] evidencing a transaction involving commerce” that concern “controvers[ies] thereafter arising out of such contract or transaction.” Securities fraud claims do not typically “arise out of” the corporate charters and bylaws.

Put simply, the waiver of rights made unilaterally through a corporate charter or other corporate document is fundamentally different than one made as a result of entering into a contract.⁹⁷

⁹³ Myriam Gilles, *Opting Out of Liability: The Forthcoming, Near-Total Demise of the Modern Class Action*, 104 Mich. L. Rev. 3, at 423 (2005), available at <https://repository.law.umich.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1545&context=mlr>.

⁹⁴ *Id.* at 30.

⁹⁵ *Id.*

⁹⁶ See, e.g., *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, 73 A.3d 934, 952 n.78, 960 n.129 (Del. Ch. 2013); See also *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014) (limiting its discussion of fee-shifting bylaws only to claims concerning intra-corporate litigation).

⁹⁷ See Law Professors Letter, at 2-3; See also Thomas L. Riesenber, SEC, Arbitration and Corporate Governance: A Reply to Carl Schneider, Insights, at 2, Aug. 1990; see also Barbara Black, *Arbitration of Investors’ Claims Against Issuers: An Idea Whose Time Has Come?*, Jul 21, 2011, available at <https://static.reuters.com/resources/media/editorial/20170718/blackonmandarb.pdf>.

FAA's Mandate Has Been Overridden by Subsequent Congressional Action

Even if a court were to conclude that bylaws and company organizational documents were, somehow, contracts that fall within the auspices of the FAA's reach and that the FAA's reach extended to claims arising out of violations of the securities laws rather than violations of the contract itself, the FAA would still not likely be held to compel mandatory shareholder arbitration. That's because the FAA's mandate has been overridden by a contrary congressional command.⁹⁸

The FAA was adopted in 1925.⁹⁹ When developing the Securities Act of 1933 and the Securities Exchange Act of 1934, Congress was well aware of the FAA, which it had adopted less than a decade earlier. Yet, in these later-drafted federal securities laws, Congress expressly drafted the right to sue, conferred appropriate jurisdiction onto the courts, and included strong anti-waiver language. As perhaps the clearest indication that Congress, the courts, and corporate issuers all correctly understood the contours of the law, there is no record of this issue being tested for several decades.

In fact, it was more than fifty years after the federal securities laws were enacted that a corporate issuer first attempted to include mandatory shareholder arbitration. As discussed above, that effort was swiftly rebuffed by the SEC.¹⁰⁰ The SEC's determination could have been challenged in court, but it wasn't.

Over the next few years, both the PSLRA¹⁰¹ and SLUSA expressly discussed the methods, standards, and procedures for private legal action. Both of those laws were intended to address perceived abuses of securities class actions, and yet in neither did Congress take the step of permitting mandatory shareholder arbitration. To the contrary, Congress clearly expressed its intent that the right to participate in class actions should be preserved and, when litigated, such actions should be litigated in federal court.

As noted above, the House Conference Report on PSLRA called private securities litigation "an indispensable tool with which defrauded investors can recover their losses without having to rely on government action."¹⁰² Leading Republican senators echoed this view. Sen. Richard Shelby (R-AL) noted that private actions "are the primary means through which defrauded investors can

⁹⁸ *American Express Company, et al. v. Italian Colors Restaurant et al.*, 133 S. Ct. 2304, (2013) (citing *CompuCredit Corp. v. Greenwood*, 565 U. S. ___, ___ (2012) (slip op., at 2–3) (quoting *Shearson/American Express Inc. v. McMahon*, 482 U. S. 220, 226 (1987))).

⁹⁹ Pub.L. 68–401, 43 Stat. 883 (1925) (codified at 9 U.S.C. §1 et seq.).

¹⁰⁰ Carl W. Schneider, *Change, the SEC and...me: Reflections from the loyal opposition*, ABA Section of Business Law, Business Law Today, May/June 1999, available at <https://apps.americanbar.org/buslaw/blt/8-5sechange.html#arbitration> (explaining how the Commission and staff expressed "horror at the concept" and effectively demanded the provision be removed before the IPO).

¹⁰¹ Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified at 15 U.S.C. §§ 78(a) et seq.).

¹⁰² H.R. Conf. Rept. No. 104-369, pg. 31.

seek redress” and that the “threat of a suit discourages would-be violators from committing fraud.”¹⁰³ Sen. Pete Domenici (R-NM) voiced his support for “a vigorous 10(b)(5) private right of action so that shareholders who are defrauded can be made as whole as possible.”¹⁰⁴

The Conference Report for SLUSA further reinforces the view that Congress intended for securities class actions to continue according to a well-defined process. It states, for example, that, “Title 1 of S. 1260, the Securities Litigation Uniform Standards Act of 1998, makes Federal court the exclusive venue for most securities class action lawsuits. ... Additionally, consistent with the determination that Congress made in the National Securities Markets Improvement Act (NSMIA), this legislation establishes uniform national rules for securities class action litigation involving our national capital markets.”¹⁰⁵

Congress took this action in SLUSA out of concern that plaintiffs’ attorneys might try to avoid the PSLRA requirements by bringing class actions in state courts.¹⁰⁶ Mandatory shareholder arbitration would have a similar but opposite effect, allowing public companies to circumvent both congressional intent to preserve investors’ right to pursue private claims in court and the procedural protections Congress put in place in PSLRA to govern those actions.

In short, these Acts to reform private actions under the securities laws, adopted after the Commission had denied an issuer’s effort to adopt a mandatory arbitration clause and after the Court had approved mandatory arbitration of customer-broker disputes, represent a clear override of the FAA mandate through contrary congressional command. Congress could have extended that court decision to shareholder-issuer disputes, had that been consistent with Congressional intent. Instead, Congress left intact the decades-old interpretation that such provisions were contrary to the law and public policy.

Mandatory Shareholder Arbitration is Contrary to the Public Interest

The integrity of our financial markets depends upon investors’ having access to the courts to resolve claims under the federal securities laws.¹⁰⁷ Congress has

¹⁰³ Prepared Statement of Sen. Richard Shelby, Private Litigation Under the Federal Securities Laws, Hearings Before the Subcomm. on Sec. of the S. Comm. on Banking, Housing, & Urban Affairs, 103d Cong. 113 (1993), available at https://archive.org/stream/privatelitigatio00unit/privatelitigatio00unit_djvu.txt.

¹⁰⁴ Prepared Statement of Sen. Pete V. Domenici, Private Litigation Under the Federal Securities Laws, Hearings Before the Subcomm. on Sec. of the S. Comm. on Banking, Housing, & Urban Affairs, 103d Cong. 113 (1993), available at https://archive.org/stream/privatelitigatio00unit/privatelitigatio00unit_djvu.txt.

¹⁰⁵ H.R. Conf. Rept No. 105-803, pg 13.

¹⁰⁶ *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 82 (2006).

¹⁰⁷ Law Professors Letter, at 3.

clearly and unambiguously stated the policy rationale for permitting private rights of action in securities fraud cases.

Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action. Such private lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs.¹⁰⁸

That view has been echoed by members of Congress and SEC officials from both parties over the years. Former SEC Chairman Richard Breeden has stated, for example, that, “Private rights of action are an essential enforcement tool to protect investors against fraud. Private suits under Section 10(b) of the Securities Exchange Act and Rule 10(b)(5) thereunder, for example, are instrumental in recompensing investors who are cheated through the issuance of false and misleading information or by other means.”¹⁰⁹ The former SEC Director of Enforcement William R. McLucas stated that, “Given the continued growth in the size and complexity of our securities markets, and the absolute certainty that persons seeking to perpetrate financial fraud will always be among us, private actions will continue to be essential to the maintenance of investor protection.”¹¹⁰

The SEC’s Resources, Priorities, and Purposes are Different than Those of Private Litigants

There is a very pragmatic reason why Congress, courts, and the SEC have all recognized the importance of private actions to enforce the antifraud provisions of the federal securities laws: resources. As McLucas explained in his PSLRA testimony, “The Commission ... will never be able to investigate or prosecute every instance in which a public company’s disclosure is questionable or where investors have been injured by less than accurate disclosure.” For this reason, he added, “SEC enforcement proceedings cannot be an adequate substitute for private rights of action.”¹¹³

¹⁰⁸ Joint Explanatory Statement of the Committee of Conference on H.R. 1058, 31, reprinted in 2 U.S.C.A.N. 730 (104th Cong., 1st Sess. 1995)(report to the Private Securities Litigation Reform Act of 1995, which sought to reduce perceived “meritless” suits through procedural and other means).

¹⁰⁹ Prepared Statement of Richard C. Breeden, Chairman, Securities and Exchange Commission, to Senator Domenici, August 12, 1992, Private Litigation Under the Federal Securities Laws, Hearings Before the Subcomm. on Sec. of the S. Comm. on Banking, Housing, & Urban Affairs, 103d Cong. 113 (1993).

¹¹⁰ Statement of William R. McLucas, Director, Division of Enforcement, SEC, Private Litigation Under the Federal Securities Laws, Hearings Before the Subcomm. on Sec. of the S. Comm. on Banking, Housing, & Urban Affairs, 103d Cong. 113 (1993).

¹¹¹ Hon. Luis A. Aguilar, Commissioner, SEC, Defrauded Investors Deserve Their Day in Court, Apr. 11, 2012, available at <http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1365171490204#.UjhoQuDDIQs> (“It is unrealistic to expect that the Commission will have the resources to police all securities frauds on its own, and as a result, it is essential that investors be given private rights of action to complement and complete the Commission’s efforts.”); see also Donald C. Langevoort, *Managing the “Expectations Gap” in Investor Protection: The SEC and the PostEnron Reform Agenda*, 48 Vill. L. Rev. 1139, 1161 (2003) (“Unless there is a vastly enlarged SEC, private actions inevitably must serve as an enforcement substitute for deterrence purposes, as well as their more traditional role as an avenue for appropriate compensation of victims.”).

¹¹² Private Litigation Under the Federal Securities Laws, Hearings Before the Subcomm. on Sec. of the S. Comm. on Banking, Housing, & Urban Affairs, 103d Cong. 113 (1993) (statement of William R. McLucas, Director, Division of Enforcement, SEC).

¹¹³ *Id.*

In addition, the factors influencing private litigation are often quite different than those influencing the Commission's decisions to investigate and prosecute a case. Some scholars have noted, for example, that class actions "are typically limited to seeking money damages," while the SEC has "a wider range of sanctions available in enforcement actions."¹¹⁷ As a result, in an SEC action, "different types of sanctions may be bargained away in negotiating a settlement," and the SEC may end up "trading off sanctions against the company and sanctions against individuals."¹¹⁸

The SEC may also have to consider other issues that do not necessarily impact private actors the same way. For example, the agency may seek to focus on easy, quick, and non-contentious cases to establish its public record of enforcement. It may similarly seek to shy away from politically fractured cases, cases that are particularly likely to be highly protracted and costly to pursue, or those that are likely to raise the ire of members of Congress (who control its budget).

These concerns are not just hypothetical. The SEC and its staff are aware of these realities. For example, a 2009 Government Accountability Office (GAO) study explained that SEC "Enforcement [Division] management and investigative attorneys told us that resource challenges hinder the ability to bring cases."¹¹⁹

It is not surprising that these different motivations and tools may often lead to different results.¹²⁰ That isn't a quirk in the system: it's a feature. Having more than one cop on the beat helps reduce the risks of under-enforcement, and may even pressure the SEC to be more responsive to public concerns.

This dual system of public and private enforcement brings additional benefits. When investors are harmed, they need not wait for the apparatus of government to protect their interests; they are empowered to do it themselves.¹²¹ And companies or executives who would commit securities fraud need not fear only the SEC, with its limited resources, but also private plaintiffs.

¹¹⁴ *Examining the SEC's Agenda, Operations, and Budget: Hearing Before the H. Committee on Financial Services*, 115th Cong. (2017) (statement of Jay Clayton, Chairman, SEC), available at <https://financialservices.house.gov/uploadedfiles/hhrg-115-ba00-wstate-jclayton-20171004.pdf>.

¹¹⁵ JPMorgan Chase & Co., About Us, available at <https://www.jpmorganchase.com/corporate/About-JPMC/about-us.htm> (reflecting 250,000 employees) (last viewed June 29, 2018).

¹¹⁶ *Examining the SEC's Agenda, Operations, and Budget: Hearing Before the H. Committee on Financial Services*, 115th Cong. (2017) (statement of Jay Clayton, Chairman, U.S. Securities and Exchange Commission), available at <https://financialservices.house.gov/uploadedfiles/hhrg-115-ba00-wstate-jclayton-20171004.pdf>.


¹¹⁷ Stephen J. Choi and A.C. Pritchard, SEC Investigations and Securities Class Actions: An Empirical Comparison, June 3, 2015, U of Michigan Law & Econ Research Paper No. 12-022; NYU Law and Economics Research Paper No. 12-38., available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2109739.

¹¹⁸ *Id.*

¹¹⁹ Government Accountability Office, Securities and Exchange Commission, Greater Attention Needed to Enhance Communication and Utilization of Resources in the Division of Enforcement, GAO-09-358, at 17 (May, 2009), available at <https://www.gao.gov/assets/290/288156.pdf>.

¹²⁰ See *infra*, note 138, discussion regarding Stephen J. Choi and A.C. Pritchard, *SEC Investigations and Securities Class Actions: An Empirical Comparison*, June 3, 2015, U of Michigan Law & Econ Research Paper No. 12-022; NYU Law and Economics Research Paper No. 12-38., available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2109739.

¹²¹ See H.R. Conf. Rept. No. 104-369, at 31 (1995) ("Private securities litigation is an indispensable tool with which defrauded investors can recover their losses without having to rely on government action.")



As of early 2018, the government agency principally tasked with enforcing the federal securities laws, the SEC, had 4,600 total employees.¹¹⁴ While that may seem like a sizeable workforce, it is less than two percent of the number of employees of just one of the firms, JPMorgan Chase & Co.,¹¹⁵ that the SEC is responsible for overseeing. Yet, with this limited staff, the SEC is responsible for overseeing:

- 8,100 public companies;
- 26,000 registered entities, including broker-dealers, investment advisers, and clearinghouses; and
- Approximately \$72 trillion in securities trading—each year.¹¹⁶

(Continued ...)

Mandatory Shareholder Arbitration Would Weaken Deterrence of Misconduct by Making it Uneconomical to Pursue Meritorious Claims

One of the primary objectives for permitting private rights of action to enforce the federal securities laws is that private plaintiffs serve as a powerful deterrent to misconduct.¹²² In fact, many legal scholars, including conservative Judge Richard Posner, have argued that the primary purpose of permitting private actions for securities fraud was deterrence (as opposed to just compensation). Mandatory shareholder arbitration would undermine this deterrent impact, both by eliminating class actions and by making individual claims uneconomical to pursue.¹²³ As the then SEC Assistant General Counsel argued in 1990, “where the Congressional purpose underlying the private right is primarily to deter wrongful conduct rather than to compensate the victim, arbitration cannot be required.”¹²⁴

The important role of private litigation as a deterrent, and the need for class actions as a mechanism to fulfill that responsibility, may be best demonstrated by example. Suppose a company with 100 million shares outstanding, and a current stock price of \$20 per share, engages in fraudulent accounting practices. Suppose further that the fraud is revealed in an SEC settlement. Once the fraud is revealed, the stock price drops to \$19 per share, a 5% decline. Arguably, the fraud may have led to losses of \$100 million, and an investor holding a million shares would lose roughly \$1 million.

Even a loss of this magnitude would likely be barely sufficient to engage the appropriate legal and economic experts to effectively prosecute the claim. These cases often involve complex discovery involving significant numbers of documents, legal experts, accountants, market impact analysts, economists, trading experts, and more. These services all require significant training and expertise, and often come at significant cost — costs that are typically borne by plaintiff’s counsel until an award is made or settlement is reached

In the class action against Petrobras, for example, plaintiffs’ counsel’s reported out-of-pocket expenses totaled \$14.5 million. These charges, which were not duplicated in the law firms’ billing rates according to court documents, included the costs of experts and consultants, online legal and factual research, costs associated with the electronic discovery platform that counsel used to search, review, and analyze documents produced during the course of the action, court fees, translation fees, travel expenses, copying costs, court reporting services, postage and delivery expenses, and mediation fees.¹²⁵

(Continued ...)

That is just the beginning. The SEC is also responsible for oversight of over a thousand filings by self-regulatory organizations and tens of thousands of regulatory filings by corporate issuers, brokers, investment advisers, and other regulated firms make each year.

¹²² See H.R. Conf. Rept. No. 104-369, pg. 31 (1995) (“[P]rivate lawsuits promote public and global confidence in our capital markets and help to deter wrongdoing and to guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs.”).

¹²³ Richard Posner, *An Economic Analysis of Law* 398 (3d Ed. 1988).

¹²⁴ Thomas L. Riesenber, *SEC, Commentary, Arbitration and Corporate Governance: A Reply to Carly Schneider, Insights*, Vol. 4, No. 8, at 4, August 1990.

¹²⁵ Memorandum of Law in Support of Class Counsel’s Motion for an Award of Attorneys’ Fees and Reimbursement of Litigation Expenses, *In re Petrobras Securities Litigation*, Case No. 14-cv-9662 (JSR), S.D.N.Y. Apr. 20, 2018, available at http://www.petrobrassecuritieslitigation.com/docs/Fee_Brief_787.pdf.

Similarly, in the Household International case, plaintiffs' counsel's reported litigation expenses totaling \$34.3 million. A significant component of those expenses was for experts, according to court documents, including experts in the field of loss causation and damages, accounting and predatory lending.¹²⁶ In particular, as court filings detailed, "Plaintiffs' loss causation and damages expert – Professor Fischel – issued six reports, sat for two depositions, testified at trial, responded to issues raised by defendants' four experts in the part of the case that was subject to the most scrutiny on appeal and at the time of Settlement, and was prepared to testify at trial a second time."¹²⁷ It is simply inconceivable that an individual could have afforded these costs, but the litigation ultimately resulted in a \$1.575 billion settlement for investors, a significant outcome both in terms of compensating victims and in deterring further wrongdoing.

While on the high end, these expenses are not outside the norm. A comparison of plaintiffs' out-of-pocket expenses for 16 high-profile securities class actions, included in court filings in the Household International case,¹²⁸ found expenses ranging from a low of \$1.2 million in the Madoff case¹²⁹ to a high of \$34.3 million and \$28.9 million respectively in the Household International¹³⁰ and Tyco International¹³¹ cases. Nine of the 16 cases included in the comparison had out-of-pocket expenses of more than \$6 million.¹³² Settlement amounts in the cases ranged from a low of \$219.9 million in the Madoff case to a high of \$3.2 billion in the Tyco case.

Even much smaller cases can pose litigation costs totalling hundreds of thousands of dollars. In a class action against Barrick Gold Corporation that settled for \$24 million, for example, litigation costs for everything from investigation and discovery efforts, experts, and mediation to postage and copying totaled just over a million dollars (\$1.06 million), according to court documents.¹³³ Plaintiffs' counsel requested reimbursement for out-of-pocket costs of \$581,565.70 in a class action against Medicis Pharmaceutical Corporation that settled for \$18 million.¹³⁴

¹²⁶ Plaintiffs' Motion and Memorandum of Law in Support of Motion for an Award of Attorneys' Fees and Expenses and Reasonable Costs and Expenses for Lead Plaintiffs, Lawrence E. Jaffe Pension Plan v. Household International, Inc., Case No. 1:02-cv-05893, N.D. Ill., Aug. 29, 2016, available at <http://householdfraud.com/docs/2222.pdf>.

¹²⁷ *Id.* at 27.

¹²⁸ Plaintiffs' Motion and Memorandum of Law in Support of Motion for an Award of Attorneys' Fees and Expenses and Reasonable Costs and Expenses for Lead Plaintiffs, Exhibit D, Lodestar Comparison, Lawrence E. Jaffe Pension Plan v. Household International, Inc., Case No. 1:02-cv-05893, N.D. Ill., Aug. 29, 2016, available at <http://householdfraud.com/docs/2222.pdf>.

¹²⁹ *Id.* (Bernard L. Madoff Investment Securities LLC/Income Plus Investment Fund (S.D.N.Y. 2013), which settled for \$219.9 million).

¹³⁰ *Id.* (Household Int'l. (N.D. Ill. 2016), which settled for \$1.575 billion).

¹³¹ *Id.* (Tyco Int'l, Ltd. (D.N.H. 2007), which settled for \$3.2 billion).

¹³² *Id.* (In addition to Household International and Tyco, these include American International Group, Inc. at \$14.7 million, Merck at \$9.5 million, Bank of America/Merrill Lynch Merger at \$8.1 million, Countrywide Financial Corp. at \$8.1 million, Marsh & McLennan Companies, Inc. at \$7.8 million, Citigroup Bonds, at \$7.3 million, and Lehman Brothers Holdings, Inc. at \$6.3 million).

¹³³ Joint Declaration of Plaintiffs' Co-Lead Counsel in Support of Final Approval of Settlement, Plan of Allocation and Co-Lead Counsel's Application for an Award of Attorneys' Fees and Reimbursement of Expenses, Richard Wagner v. Barrick Gold Corp., Case No. 1:03cv403, S.D.N.Y., Sept. 8, 2009.

¹³⁴ Declaration of Jeremy A. Lieberman in Support of Final Approval of Settlement, Plan of Allocation, Award of Attorneys' Fees and Expenses, and Compensatory Awards for Class Plaintiffs, In re Medicis Pharmaceutical Corporation Securities Litigation, Case 2:08-cv-01821-GMS, D. Ariz., Jan. 19, 2012.

Again, even in cases such as these where litigation costs fall on the lower end of the spectrum, it is unreasonable to expect that individual shareholders will be able to bear these costs if the opportunity to participate in class actions is foreclosed.

The same affordability issue arises in our hypothetical example. While a single investor owning a million shares might *conceivably* be able to find an attorney willing to risk the cost of arbitrating the claim, what happens if no single investor owns more than a million shares? The basic economics would preclude all of the smaller investors from even engaging without doing so at a certain loss—something they may even be legally prohibited from doing.¹³⁵ As a result, despite the fraud, and the \$100 million in losses to investors, the company might not be forced to pay anything to investors if those investors are forced to bring their claims individually in arbitration.

If companies can walk away from a major fraud by paying a modest fine to the SEC, will that be sufficient to deter fraud?

Mandatory Shareholder Arbitration Would Reduce Deterrence by Reducing Settlement Amounts

There is also a significant difference between the recoveries and damages the SEC and the investors might receive through their separate actions. The SEC can typically bring cases for disgorgement of ill-gotten gains, as well as penalties. But that may be significantly less than the actual losses suffered by investors. For example, the accounting fraud in our hypothetical above could have been to simply cover up a \$5 million loss, and the company may have sold no new shares since engaging in the fraud. It would be hard to argue, in that case, that the company enjoyed massive “ill-gotten gains” as a result of its fraud, even though investors suffered significant losses. As a result, any recovery for investors by the SEC would likely be minimal.

Because of this and other differences in the scope of recoveries between private plaintiffs and the SEC, and as discussed in detail below, the amount of any settlement with the SEC is often a fraction of what it could be for a class action suit. And this is precisely what evidence comparing SEC actions to class action recoveries makes clear.¹³⁶

¹³⁵ Many investors have legal fiduciary duties to their customers or beneficiaries. Using funds to prosecute claims wherein the cost of pursuing the claim is almost certain, if not certain, to exceed any potential recovery would likely violate such duties.

¹³⁶ See James D. Cox and Randall S. Thomas, SEC Enforcement Heuristics, 53 Duke Law Review 737 (2003), available at <https://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=1208&context=dj> (finding that many private suits not involving a parallel SEC enforcement action settle for 20 or more percent of provable losses, concluding the SEC cannot and does not prosecute all violations and the private suit picks up the slack. Also stating that, “In several respects, we might conclude that the total volume of SEC enforcement proceedings is quite modest compared to those possible.”); See also Choi and Pritchard, *infra*, note 138.

For example, as discussed in greater detail below, in just five major fraud cases, private investors were able to recover \$19.4 billion, while the SEC obtained penalties and fees of just \$1.8 billion in these same five cases.¹³⁷ Put simply, the private actions were not only more effective at compensating defrauded investors, they were also a larger deterrent to fraud.¹³⁸ Further, the mere risk of a much larger financial impact will serve as warning and powerful prophylactic to fraud.

The efficacy of private lawsuits as a deterrent for misconduct is also well-understood by securities defense lawyers and is prominently featured in nearly every SEC settlement. Lawyers for companies and their executives who settle fraud cases with regulators will often negotiate “neither admit nor deny” language in their regulatory settlements precisely to forestall private plaintiffs from directly utilizing the settlement in their private actions.¹³⁹ They recognize that the dollars associated with private actions are often significantly greater than those for regulatory settlements, and they work hard to forestall such actions.

Fear of regulatory enforcement actions is one thing, but fear of the private securities class action lawsuits is quite another.

Going back to our hypothetical example, imagine that shareholders had to rely on arbitration instead of the class action to recover their losses. In that case, the total dollars claimed by investors could easily be zero against the company that committed the fraud — despite investor losses of \$100 million. That is because, as discussed above, none of the investors may individually have a sufficient stake and resources to prosecute the claim. And even if a few very large institutional investors did have the capacity to bring individual claims, their recoveries, while individually significant, would be collectively trivial when compared to the total losses suffered. This difference fundamentally impacts the efficacy of private actions as a deterrent for misconduct.

¹³⁷ Paul Bland, *Trump's SEC may negate investors' ability to fight securities fraud*, THE HILL, Feb. 20, 2018, available at <http://thehill.com/opinion/finance/374711-trumps-sec-may-negate-investors-ability-to-fight-securities-fraud> (citing to settlements related to Enron, WorldCom, Tyco, Bank of America, and Global Crossing). Notably, not all of the amounts collected by the SEC were returned to investors. Thus, investor recoveries may be far less than the total settlements by the SEC.

¹³⁸ We note that the SEC, as a regulator, also has other deterrent tools not available to private litigants, including prohibitions on individuals serving as certain corporate officers or directors in public companies, and its ability to prevent the corporate wrongdoers from engaging in certain activities, such as making private offerings under Rule 506.

¹³⁹ See, e.g., Patrick McGeehan, *How Settlement Is Worded Could Be Costly to Merrill*, N.Y. TIMES, May 10, 2002, available at <https://www.nytimes.com/2002/05/10/business/how-settlement-is-worded-could-be-costly-to-merrill.html> (noting “[o]ne reason securities firms settle so many cases with the Securities and Exchange Commission, rather than fighting them in court, is that those agreements are not admissible in subsequent lawsuits by investors. The firms do not want to provide ammunition for class-action suits that could cost them millions or even billions of dollars in damages.”).

Mandatory Arbitration Would Reduce Deterrence by Eliminating an Important Tool for Identifying Misconduct

Our hypothetical example assumes the SEC had already identified the fraud and prosecuted it. But investors' independent ability to prosecute their securities fraud claims provides an essential tool to identify misconduct that might otherwise have gone undetected and to recover without any government action.

In fact, two academic researchers, Stephen J. Choi and A.C. Pritchard — comparing the relative precision of targeting by the SEC and plaintiffs' lawyers using three market-based metrics of information asymmetry — concluded that private plaintiffs more accurately identify and target misconduct than the SEC enforcement staff.¹⁴⁰ Private plaintiffs achieve this more accurate targeting despite lacking the SEC's subpoena power and operating under heightened pleading standards imposed by PSLRA.

If investors were forced to resort to arbitration, the role of private litigation in surfacing misconduct would be significantly weakened. Many, if not most, investors would not be adequately incentivized to do the research and work needed to identify and prosecute their potentially meritorious claims. This would necessarily translate to fewer frauds' being investigated, as well as fewer recoveries by investors for lesser amounts.

Mandatory shareholder arbitration would also significantly weaken deterrence by dramatically limiting public accountability for misconduct. To the degree that they occur at all, arbitrations of securities fraud would likely be far less frequent and for much smaller overall dollars than class action lawsuits have been. As a result, they would be less likely to be picked up by the press, analysts, policymakers, or investors. They could also potentially include provisions requiring confidentiality, a result that would run counter to the public policy of identifying and policing misconduct in the securities markets.

¹⁴⁰ See, e.g., Stephen J. Choi and A.C. Pritchard, SEC Investigations and Securities Class Actions: An Empirical Comparison, June 3, 2015, U of Michigan Law & Econ Research Paper No. 12-022; NYU Law and Economics Research Paper No. 12-38., available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2109739. Culpability for disclosure violations will be relevant to the resolution of both SEC enforcement proceedings and class actions, but the SEC has a wider range of sanctions available in its enforcement actions. That broader range of sanctions may influence the monetary component of settlements in SEC actions because different types of sanctions may be bargained away in negotiating a settlement. In addition, the SEC may be trading off sanctions against the company and sanction against individuals. By contrast, class actions are typically limited to seeking money damages (and plaintiffs' attorneys are compensated with a percentage of those damages), and those damages are typically paid by the company and its insurer. ("We compare the relative precision of targeting by the SEC and plaintiffs' lawyers using three market-based metrics of information asymmetry: changes in earnings response coefficients, institutional ownership, and the bid-ask spread. Prior work suggests that these measures correlate with the market's perception of the likelihood of fraud. We also examine the decisions of corporate boards to terminate CEOs and CFOs in response to SEC investigations and class actions. We argue that boards have access to non-public information relating to the officer's culpability, so the termination decision may also proxy for the likelihood of fraud. **Overall, the evidence we present here contradicts the conventional wisdom that the SEC targets disclosure violations more precisely than plaintiffs' lawyers.**") (emphasis added)

¹⁴¹ See, e.g., *In re United Health Grp. Inc. PSLRA Litig.*, 643 F. Supp. 2d 1094 (D. Minn. 2008); Press Release, CalPERS, "UnitedHealth Group Reach \$895 Million Settlement in Class-Action Case – Includes Landmark Corporate Governance Reforms," (July 2, 2008), http://s3.amazonaws.com/fcmd/documents/documents/000/003/226/original/UnitedHealth_Group_-_Calpers_CALPR.pdf?1426791366; *In re Cendant Corp. Litig.*, 264 F.3d 201, 219 (3d Cir. 2001).

Lastly, as discussed below, arbitrations seem unlikely to lead to ongoing corporate governance reforms, which are often specifically tailored to deter future misconduct.¹⁴¹

Mandatory Arbitration Would Reduce Deterrence by Frustrating the Development, Clarification, and Publication of Law

Because of their often confidential nature, the absence of any requirement for arbitrators to follow the law, and the lack of judicial review, mandatory shareholder arbitration would provide almost none of the public record of facts and precedential value of lawsuits. The federal securities laws have been fleshed out in numerous high-profile court decisions, impacting both SEC and private enforcement. And a significant portion of those seminal opinions were delivered in private litigation. As former SEC Commissioner Elisse Walter has explained:

[T]here have been many important judicial decisions in private litigation involving issues that overlap with Commission cases. They have included decisions on core issues including the definition of “security,” such as *Reves*; when fraud is “in connection with” securities purchases or sales, such as *Superintendent*; the degree of intent needed to violate the antifraud provisions of the Securities laws, such as *Hochfelder*; and the contours of the element of materiality under Rule 10b-5, such as *Basic v. Levinson*.¹⁴²

Further, the publication of legal opinions resulting from litigation in court offers guidance to executives, lawyers, businesses, and transaction planners on how to comply with the federal securities laws and allows for a more robust process for informed evolution of the law. This impact, often called “the decree effect,” may be significant.¹⁴³ It deters future misconduct by providing public notice of permissible and impermissible behavior. This both improves the

¹⁴² Elisse Walter, Remarks Before the FINRA Institute at Wharton Certified Regulatory and Compliance Professional (CRCP) Program, Aug. 11, 2011, available at <https://www.sec.gov/news/speech/2011/spch110811ebw.htm>.

¹⁴³ See, e.g., William B. Rubenstein, *Why Enable Litigation? A Positive Externalities Theory of the Small Claims Class Action*, 74 UMKC L. REV. 709, 723–24 (2006) (“The legal principle developed in the case will create more certainty in structuring social behavior and lower the need for future adjudication concerning the decided issue. If future litigation does arise, the decree from the initial case will serve as *stare decisis*, hence making resolution of later cases more efficient. Beyond these general legal effects, the decree in the initial case could also be used to preclude re-litigation of factual issues in future cases among the same or similarly situated litigants. And most immediately, the decree may actually require a party to cease a practice affecting a group of individuals, even though the initial case was prosecuted by only one of them. An individual lawsuit that produces a judicial decision thereby has generated significant social benefits in terms of shaping conduct, reducing litigation costs, and preserving judicial resources.”).

integrity of the overall markets and conserves SEC resources, which might otherwise be spent attempting to issue guidance or engaging in examinations or enforcement actions related to similar conduct by other participants.

For all of the above reasons, mandatory shareholder arbitration would undermine the key role of private actions to deter misconduct, an essential element of ensuring the integrity of U.S. capital markets on which the health of our economy depends.

Arbitration Undermines Fair and Consistent Application of the Law

Because arbitrators are not required to follow the law and judicial review is limited, a system that relies on mandatory arbitration undermines the fair and consistent application of the law. This poses risks for investors, that their meritorious claims will be unfairly denied or inadequately compensated. But it also poses countervailing risks for companies, that frivolous claims will be unfairly granted or awards for meritorious claims will be excessive.

If arbitration were to become the norm for resolving shareholder disputes, arbitrators would not be required to follow legal precedent, plaintiffs might not be required to meet the same standard of proof that would apply in court, and the opportunity for judicial review of erroneously decided cases would be limited. In particular, by freeing plaintiffs from the provisions of PSLRA — such as heightened pleading standards and penalties for frivolous claims — mandatory shareholder arbitration would serve to circumvent the carefully crafted system Congress put in place to govern such suits and limit frivolous litigation.

At the very least, there would be no way to ensure that the law is being fairly and consistently applied, given the opacity of the arbitration process. Where there is no record by which to determine whether one of the exceedingly narrow circumstances for a court to overturn the arbitration decision has been met, judicial review becomes even more difficult to invoke.¹⁴⁴

¹⁴⁴ Section 10 of the Federal Arbitration Act (FAA) lists four specific grounds for vacating an arbitration award, all of which generally concern the process by which the arbitration was conducted. In particular, it permits a district court to vacate an arbitration award if: (1) the award “was procured by corruption, fraud, or undue means”; (2) “there was evident partiality or corruption in the arbitrators”; (3) the arbitrators engaged in misbehavior by refusing to consider material evidence, refusing without cause to postpone a hearing, or other acts that prejudiced one of the litigants; or (4) 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.” 9 U.S.C. § 10. For more than four decades, courts applied a “manifest regard of the law” standard when reviewing arbitration decisions. However, after the Supreme Court’s holding in *Hall Street Associates LLC v. Mattel, Inc.*, 552 U.S. 576, 586-87 (2008), that the statutory grounds for vacatur in section 10 are exclusive, the circuits have split on whether manifest disregard remains a viable ground for vacating an arbitration award.

Private Litigation Leads to More and Larger Recoveries for Investors than SEC Actions

Private litigants may bring actions not brought by the SEC, or they may much more aggressively pursue their claims. As a result, although the number of total class action claims filed each year totals only in the few hundred,¹⁴⁵ the total dollars recovered each year is in the billions.¹⁴⁶ For example, awards from 81 securities class actions settled in 2017 totaled a relatively low \$1.5 billion, according to Cornerstone Research. The 2016 total was \$6.1 billion from 85 settlements.¹⁴⁷

While quantitative measures of enforcement effectiveness are inherently limited, an examination of a series of extremely egregious and well-publicized securities frauds in the United States in the early 2000s provides a useful contrast between the effectiveness of public and private enforcement in compensating victims.

- The five corporate frauds in question — involving Enron, WorldCom, Tyco, Bank of America and Global Crossing — were some of the worst in generations, costing investors tens of billions of dollars in losses. Investors, through their own private lawsuits, were ultimately able to recover \$19.4 billion for the five frauds.¹⁴⁸
- When it comes to compensating victims, government enforcement actions were much less effective. The SEC obtained penalties and fees totaling \$1.8 billion in these five cases — only a fraction of which was ultimately used to compensate the injured investors.¹⁴⁹

The different results of private lawsuits, SEC actions, and mandatory shareholder arbitration can perhaps best be illustrated by three examples: Enron, Petrobras, and Household International.



In the late 1990s, Enron Corporation grew rapidly into one of the world's largest energy companies, with over 20,000 employees and a web of energy and communications assets. Then, from the middle of 2000 until its eventual bankruptcy in December 2001, the company began a rapid downward spiral as its widespread accounting fraud, involving complex off-balance sheet entities designed to hide the company's burgeoning debt

¹⁴⁵ See Stanford Law School Securities Class Action Clearinghouse, a collaboration with Cornerstone Research, <http://securities.stanford.edu/>.

¹⁴⁶ See Stanford Law School Securities Class Action Clearinghouse, a collaboration with Cornerstone Research, Heat Maps & Related Filings, Litigation Status, Case Settled, <http://securities.stanford.edu/litigation.html?filter=CASE%20SETTLED>

¹⁴⁷ Press Release, Cornerstone Research, "Securities Class Action Settlement Dollars Dip Dramatically in 2017: The number of settlements remain at relatively high levels," (Mar. 14, 2018), <https://www.cornerstone.com/Publications/Press-Releases/Securities-Class-Action-Settlement-Dollars-Dip-Dramatically-in-2017>

¹⁴⁸ Paul Bland, *Trump's SEC may negate investors' ability to fight securities fraud*, The Hill, Feb. 20, 2018, available at <http://thehill.com/opinion/finance/374711-trumps-sec-may-negate-investors-ability-to-fight-securities-fraud>.

¹⁴⁹ *Id.*

SEC Struggles to Compensate Victims

Compensating injured investors has not historically been an SEC priority. In response to the Enron and WorldCom scandals, however, Congress established the Federal Account for Investor Restitution ("Fair Fund") under Section 308 of the Sarbanes-Oxley Act. It provided a mechanism to help the SEC return disgorged profits and civil penalties to investors harmed by corporate wrongdoing in any suit in which both civil penalties and disgorgements had been levied against the defendant.

Unfortunately, the SEC has had only limited success at recovering and distributing funds to injured investors.

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Over the years, numerous Government Accountability Office reports have demonstrated that the SEC has lacked a reliable method by which to identify and collect data on Fair Fund cases, and it has taken extremely long periods of time to collect and distribute funds.¹⁵³ The usage of Fair Funds is also extremely limited. In 2010, for example, the SEC set up only one fund to compensate investors.¹⁵⁴ The dollars involved consistently constitute just a small fraction of the ultimate harms of the frauds involved—and have been orders of magnitude smaller than private litigation recoveries. Thus, the vast majority of sums collected by the SEC each year go where they have always gone: to the U.S. Treasury, and not to injured investors.

and toxic assets, came to light. As the company's share price plummeted from over \$90 a share to zero over the course of less than a year and a half, millions of investors lost as much as \$30 billion in the wreckage. Over the next seven years, investors successfully recovered over \$7.2 billion in private claims related to the fraud.¹⁵⁰ By way of contrast, the SEC's restitution fund for investors totaled just \$440 million as of February 2007.¹⁵¹ In other words, private lawsuits recovered more than 15 times what the SEC did for investors. Given the extreme complexity and high cost of prosecuting the Enron fraud,¹⁵² had the company been free to adopt a mandatory arbitration requirement for shareholders, the SEC's \$440 million fund would likely have provided the only restitution that victims received.



A case involving Brazil's state-controlled oil company, Petroleo Brasileiro SA (Petrobras), illustrates the important role that U.S. protections can have for both our markets and investors. Petrobras engaged in a public offering of securities, and its shares were traded both in the United States and on the Brazilian stock exchange. Unfortunately, the company had engaged in some extremely troubling financial and operations practices and ended up deeply embroiled in a massive corruption scandal. Thanks to the protections afforded by U.S. federal securities laws, investors in the United States were able to bring a class action, *despite a forced arbitration clause banning them in Petrobras' bylaws*. Earlier this year, the company agreed to pay \$2.95 billion to investors in the American depository shares, making it the largest class action payout in the United States by a foreign entity.¹⁵⁵ Investors who had purchased their shares in Brazil were less fortunate. Forced into arbitration on an individual basis and barred from joining a class action,¹⁵⁶ they have been able to recover none of their losses. Not a dime. The SEC has still not brought a case.



Household International, Inc. ("Household") provides another example of the stark differences between SEC and private actions. Household was an Illinois-based consumer loan company. In the early 2000s, the company came under scrutiny for its lending

¹⁵⁰ Securities Class Action Clearinghouse, Stanford Law School, Enron Corporation Securities Litigation, available at <http://securities.stanford.edu/filings-case.html?id=102098>. Notably, this total was reduced by approximately 9.3%, or \$668 million, to cover plaintiffs' legal and professional fees.

¹⁵¹ SEC, Enron Claims Fund, May 14, 2007, available at <https://www.sec.gov/divisions/enforce/claims/enron.htm>.

¹⁵² According to court documents, plaintiffs' counsel's out-of-pocket expenses totaled roughly \$3.8 million and attorneys devoted more than 56,000 hours to prosecuting the case over a 4-year period. Memorandum in Support of Class Counsel's Joint Petition for an Award of Attorneys' Fees, Reimbursement of Expenses, and an Incentive Award to the Class Representatives, 49-50, *In re Enron Corp. Securities and ERISA Litigations*, https://www.hbsslaw.com/uploads/case_downloads/files/case_pdfs/Enron/Counsel_Petition_for_Fees.pdf

¹⁵³ See, e.g., Government Accountability Office, *Securities and Exchange Commission: Information on Fair Fund Collections and Distributions*, GAO-10-448R, Apr. 2010, available at <https://www.gao.gov/products/GAO-10-448R> (We have issued a number of reports on SEC's Fair Fund program and made a number of recommendations designed to help SEC improve the Fair Fund program management and internal controls.").

¹⁵⁴ Sonya M. Steinway, SEC "Monetary Penalties Speak Very Loudly," *But What Do They Say? A Critical Analysis of the SEC's New Enforcement Approach*, 124 Yale L. J. (2014), available at https://www.yalelawjournal.org/comment/sec-monetary-penalties-speak-very-loudly-but-what-do-they-say-a-critical-analysis-of-the-secs-new-enforcement-approach#_ftnref10.

¹⁵⁵ Securities Class Action Clearinghouse, Stanford Law School, Petroleo Brasileiro S.A. - Petrobras: American Depository Shares Securities Litigation, available at <http://securities.stanford.edu/filings-case.html?id=105312>.

¹⁵⁶ *In re Petrobras Securities Litigation*, 116 F. Supp. 3d 368, 386-389 (S.D.N.Y. 2015) (dismissing claims asserted under Brazilian law based on a finding that they were subject to mandatory arbitration).

practices, loan delinquency programs, and workout programs. It made several materially misleading statements in order to inflate its share price by hiding its poor lending practices and loan quality. Investors ultimately suffered billions of dollars in losses as a result. Several state regulators brought actions for predatory lending practices against the company, and the SEC ultimately brought an action for securities fraud. But the SEC settlement included no money for investors.¹⁵⁷ In contrast, HSBC, which bought Household shortly after the company started to collapse and took the private lawsuits to trial, ultimately agreeing to pay just under \$1.6 billion in compensation to the private litigants.¹⁵⁸

Mandatory Shareholder Arbitration Would Leave Many Investors Without Adequate Recourse

Advocates of mandatory arbitration clauses understand that the effect would not simply be to shift the venue in which private claims are heard, but to eliminate most such claims entirely. Although they cloak their aims as designed to eliminate frivolous litigation, the policy makes no distinction between meritorious and frivolous claims. Instead, it undermines the economic viability of all such claims for all but the largest institutional investors, and it eliminates procedural safeguards, such as a robust discovery process, necessary to prosecute them successfully. We are unaware of any evidence to suggest that smaller investors would, if subject to mandatory shareholder arbitration, nevertheless be able to effectively vindicate their Exchange Act rights.¹⁵⁹

As the SEC's own Investor Advocate recently framed the concern:

[U]nless a class-wide remedy is available there is often no other recourse for investors with small holdings. Cases involving accounting irregularities or other corporate misdeeds are usually far more complex than the typical dispute involving a consumer contract, or even a dispute against a broker or investment adviser that involves the investor's personal account. For individual investors who suffer losses in a widespread fraud, the costs of bringing claims individually in arbitration may well exceed the amount of the likely recovery. And, unless their losses are sizable, victims will struggle to find attorneys to represent them, much less

¹⁵⁷ *In the Matter of Household International Inc.*, Exchange Act Rel. No. 34-47528, Mar. 18, 2003, available at <https://www.sec.gov/litigation/admin/34-47528.htm>.

¹⁵⁸ Johnathan Stempel, *HSBC to pay \$1.575 billion, ending Household International class action*, REUTERS, June 6, 2016, available at <https://www.reuters.com/article/us-hsbc-settlement/hsbc-to-pay-1-575-billion-ending-household-international-class-action-idUSKCN0Z22NW>. For more information about this litigation, see <http://www.householdlitigation.com/>

¹⁵⁹ See *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 228-229 (1987).

experts to establish elements such as materiality, reliance, loss causation, and damages. This can lead to a collective action problem, where each investor lacks the economic incentive to bring an individual case, even though the collective losses of multiple investors would justify the costs of the litigation.¹⁶⁰

The denial of the class action process in this context appears particularly likely to leave investors with smaller claims or fewer resources unable to effectively pursue their claims. Of course, even these “smaller” claims may be significant to a retiree’s financial security.

This effect of mandatory shareholder arbitration is in direct conflict with the purpose and intent of the FAA, which reflects a federal policy favoring arbitration as a streamlined “method of resolving disputes,” not as a way to procedurally defeat valid claims.¹⁶¹ Put simply, mandatory shareholder arbitration would impermissibly weaken investors’ ability to enforce their rights under the federal securities laws.¹⁶²

Mandatory Shareholder Arbitration Would Disadvantage Smaller Investors

One of the primary benefits of class action lawsuits is that, by aggregating the injuries of all investors, they enable smaller investors who might not otherwise be financially equipped to pursue their claims to recover their losses. If these injured investors are denied class actions as a useful tool, then these types of claims will likely be lost altogether.¹⁶³

Only larger, institutional investors with the resources and exposures to individually pursue claims would be able to do so. Individual investors, such as those with a few thousand dollars in a retirement account, would be effectively shut out entirely. Because larger investors may still be incentivized and capable

¹⁶⁰ Rick Fleming, SEC Investor Advocate, Mandatory Arbitration: An Illusory Remedy for Public Company Shareholders, Remarks delivered at the Practising Law Institute’s SEC Speaks, Feb. 24, 2014, (citing Christopher R. Leslie, The Significance of Silence: Collective Action Problems and Class Action Settlements, 59 Fla. L. Rev. 71, 73 (2007)), available at <https://www.sec.gov/news/speech/fleming-sec-speaks-mandatory-arbitration>.

¹⁶¹ *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U. S. 477, 481 (1989). (also Kagan, J., dissenting in *Italian Colors*)

¹⁶² David Webber, Shareholder Litigation Without Class Actions, 57 Arizona Law Review 201, 202 (2015). available at https://scholarship.law.bu.edu/faculty_scholarship/36 (“the end of the class action means, at a minimum, abandonment of the idea that investors should be compensated for losses due to fraud or other corporate malfeasance. And I demonstrate that loss of the class action leaves investors in smaller firms with no legal remedy for wrongdoing, even if some form of litigation survives.”); See also *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 228-229 (1987).

¹⁶³ Some have argued that securities-fraud actions suffer from a circularity problem. That’s because shareholders are often both victims and the owners of the defendant corporation from which any settlement is ultimately paid. Thus, even if there is a fraud, and recovery, the recovery is seen as a circular transfer from shareholders to themselves with substantial transaction costs (e.g., attorney and expert fees). John C. Coffee, Jr., *Reforming the Securities Class-Action: An Essay on Deterrence and its Implementation*, 106 COLUM. L. REV. 1534, 1534 (2006). See also Bradley J. Bondi, *Facilitating Economic Recovery and Sustainable Growth Through Reform of the Securities Class Action System: Exploring Arbitration as an Alternative to Litigation*, 33 Harv. J. L. & Pub. Policy 607, 610 (2010).

of bringing their claims, the system will essentially bifurcate, so that larger investors may recover for frauds while smaller investors would not.

Even worse, assuming that both large and small investors still own the defendant companies (as is common), it would be the smaller investors reaching “farther into their pockets to compensate large institutional investor losses for that fraud (or mispriced deal).”¹⁶⁴ Put another way, individuals’ retirement accounts and smaller institutions could be forced to help pay larger shareholders for frauds that these smaller investors also were injured by but were unable to recover for.

Some proponents of mandatory shareholder arbitration argue that securities class actions simply shift shareholder funds from one pocket to another, with significant losses to attorneys’ fees in the process, sometimes called the “circularity” problem.¹⁶⁵ Of course, this analysis fails to reflect the benefits to all investors from the increased deterrent effects created by the class actions themselves.¹⁶⁶ It also ignores that claims are often paid in whole or in part by company insurance policies or that the claims often include assertions against key executives.

But aside from these obvious holes in that circularity argument, the mandatory shareholder arbitration “solution” would actually make that perceived problem worse in several ways. Most importantly, it would replace a circularity problem with a semi-circularity problem. Instead of having investors on both sides of an action, as harmed plaintiffs and as owners of the defendant, the plaintiff profile shrinks. That is because only investors with positive-value claims would likely sue and recover their damages.

This distinction based on economic viability of the claims introduces a distortion in which the exact same trade for the same sum would be actionable if made through a large institution, but not through a small institution or an individual. Absent the ability to join together as a class, a \$5 million loss incurred by ten different individual investors may not give rise to economically viable claims, whereas that same loss incurred by one institution would likely be economically viable.

To make matters worse, individuals and other smaller investors would in many cases still own the companies having to pay the claims. But they would likely never be the claimants; only the larger investors would.¹⁶⁷ Thus, smaller investors who may now benefit from class actions would not only be defrauded,

¹⁶⁴ David H. Webber, *Shareholder Litigation Without Class Actions*, 57 *Arizona Law Review* 201, 202 (2015), available at https://scholarship.law.bu.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1035&context=faculty_scholarship

¹⁶⁵ See, e.g., Bradley J. Bondi, *Facilitating Economic Recovery and Sustainable Growth Through Reform of the Securities Class Action System: Exploring Arbitration as an Alternative to Litigation*, 33 *Harv. J. L. & Pub. Policy* 607, 610 (2010).

¹⁶⁶ James J. Park, *Shareholder Compensation as Dividend*, 108 *Mich. L. Rev.* 323, 347 (2009).

¹⁶⁷ David H. Webber, *Shareholder Litigation Without Class Actions*, 57 *Arizona Law Review* 201, 202 (2015), available at https://scholarship.law.bu.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1035&context=faculty_scholarship.

they would also have to pay to compensate positive-value claimants for that fraud. Loss of the class action needlessly introduces a distortion in the marketplace that gives large institutions an unmerited legal advantage over smaller investors.

In short, mandatory shareholder arbitration would severely distort the marketplace between investors, to the detriment of millions of individuals and small investors.¹⁶⁸

Class Actions Lead to Improved Corporate Governance

Private litigation can also benefit shareholders by negotiating ongoing corporate governance reforms in their settlements designed to lessen the likelihood of a recurrence of misconduct.

Among the first such settlements was a 1999 settlement with Cendant over fraudulent accounting practices. In addition to cash compensation, it included requirements to increase the independence of board oversight by mandating that outside directors make up a majority of board seats and all of the seats on Cendant's auditing, nominating, and compensation committees. It also required shareholder approval before the repricing of stock options.¹⁶⁹

Over the next several years, such requirements became more common.¹⁷⁰ A 2008 class action settlement with UnitedHealth Group over its stock option grant practices was typical. It mandated a number of corporate governance reforms, including: creating a process for election of a shareholder-nominated director, enhanced standards for director independence, a mandated holding period for option shares acquired by executives, shareholder approval of any stock option re-pricing, and a requirement that incentive compensation take into consideration UnitedHealth's performance as compared to its peer group.¹⁷¹

In this way, class action settlements can serve to protect shareholders from future abuses. As a former SEC attorney and corporate governance expert put it, these sorts of settlements "can help to motivate other companies that need a kick in the pants. Some of these companies might have undertaken reform on their own once the board got wind of the reasons that led to the lawsuit. But

¹⁶⁸ To ensure that they maintain the maximum potential legal rights, individuals and other market participants may seek to utilize only the largest institutions with which to do business—because those larger ones are most likely to still be able to assert viable legal claims.

¹⁶⁹ *In re Cendant Corp. Litig.*, 264 F.3d 201, 219 (3d Cir. 2001).

¹⁷⁰ Phyllis Plitch, *Governance at Gunpoint*, THE WALL STREET JOURNAL, Oct. 17, 2005, <https://www.wsj.com/articles/SB112923095769267931>

¹⁷¹ See, e.g., *In re United Health Grp. Inc. PSLRA Litig.*, 643 F. Supp. 2d 1094 (D. Minn. 2008); Press Release, CalPERS, "UnitedHealth Group Reach \$895 Million Settlement in Class-Action Case – Includes Landmark Corporate Governance Reforms," (July 2, 2008), http://s3.amazonaws.com/fcmd/documents/documents/000/003/226/original/UnitedHealth_Group_-_Calpers_CALPR.pdf?1426791366

often these boards are subject to the settlement provisions themselves and need help getting to better governance practices.”¹⁷²

Mandatory Shareholder Arbitration Might Create Insider Trading Risks

If public companies were to mandate arbitration of all shareholder disputes, it would also create new challenges with material, non-public information. For example, what happens if an investor brings or settles an arbitration? The individual case may not be significant for the company. Does it become public? If not, would that create material, non-public information that could give rise to insider trading concerns? But what if the facts giving rise to the claim were to be asserted by all investors? The existence of the arbitration itself could create new significant, and complex, risks.

This raises the fundamental question, should the SEC permit (and incentivize) companies to essentially pay off one set of investors to hide potential legal claims from other investors?

Mandatory Shareholder Arbitration Would Deny the SEC the Ability to Assert Its Jurisdiction over the Development of the Law

Mandatory shareholder arbitration could also deny the SEC the opportunity to influence legal interpretations that directly impact its enforcement priorities. As a result, it may permit the gradual evolution of legal interpretations without clear SEC involvement.

For decades, the SEC has weighed in with courts as amici to assert its views and interpretations.¹⁷³ Former SEC Chairman David S. Ruder called the agency’s filing of such briefs “a policy making tool of great importance” and one that has enjoyed enormous success.¹⁷⁴ Ruder noted that, “an important fraction of private cases raise unresolved issues of law”¹⁷⁵ and, because “the Commission’s regulatory program relies on the same statutes as those involved in private cases, resolution of legal issues in those cases often affects the Commission’s own enforcement and rulemaking efforts.”¹⁷⁶

But “[e]ven issues which solely concern the rights of private litigants under the securities laws may have considerable public policy significance,” he added. In

¹⁷² Phyllis Plitch, *Governance at Gunpoint*, The Wall Street Journal, Oct. 17, 2005, <https://www.wsj.com/articles/SB112923095769267931> (quoting Broc Romanek, a former SEC attorney and editor the TheCorporateCounsel.net, a securities-law website).

¹⁷³ See David S. Ruder, *The Development of Legal Doctrine Through Amicus Participation: The SEC Experience*, 6 Wisc. L. Rev. 1167, 1170 (1989). <http://repository.law.wisc.edu/items/show/129454?file>

¹⁷⁴ *Id.* at 1168.

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

such cases, “the Commission may choose to make its views known in an effort to assist in important policy formulation.”¹⁷⁷

As a result, these public briefs in private litigation have not only provided the public with guidance as to the SEC’s views on key issues, but they have also helped shape the evolution of the federal securities laws, including with regard to the role of private litigation.¹⁷⁸ If private litigation is replaced by arbitration, in which outside parties do not participate as *amici*, the opportunity for the SEC to shape the interpretation of the securities laws in this way would be significantly diminished.

Policy Arguments for Mandatory Shareholder Arbitration Are Fatally Flawed

Somewhat ironically, some academics,¹⁷⁹ corporate lawyers,¹⁸⁰ and other commenters have argued that the existence of a few hundred class action filings each year, or the fact that many of the largest U.S. issuers have been recently subjected to a class action, or that investors recover billions of dollars each year from corporate issuers, somehow demonstrate “abuse” of the legal system. This “abuse,” they argue, should be curbed by mandatory shareholder arbitration. At the same time, some make the facially inconsistent argument that class actions ultimately fail to meaningfully recompense injured investors and thus can be dispensed with as offering insufficient benefits to investors and the markets.¹⁸²

These commenters seem to inappropriately discount or entirely ignore the obvious facts that:

- The actions provide an important supplement to the SEC’s enforcement process by both providing an avenue for investors to recover losses and deterring misconduct;
- Congress has already imposed heightened procedural and substantive requirements on securities class action lawsuits to ensure only high-quality claims are able to survive; and
- Despite significant hurdles, investors are able to recover billions of dollars in losses each year as a result of these actions.

¹⁷⁷ *Id.* at 1169.

¹⁷⁸ See, e.g., Brief for the SEC, at 20, *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987) (arguing for the permissibility of arbitration in broker-customer disputes, while distinguishing from areas outside of the SEC’s oversight.).

¹⁷⁹ See, e.g., Hal S. Scott and Leslie N. Silverman, *Stockholder Adoption of Mandatory Individual Arbitration for Stockholder Disputes*, 36 Harv. J. L. & Pub. Policy 1187, 1194 (2013).

¹⁸⁰ See, e.g., Bradley J. Bondi, *Facilitating Economic Recovery and Sustainable Growth through Reform of the Securities Class-Action System: Exploring Arbitration as an Alternative to Litigation*, 33 Harvard J. L. & Pub. Policy 607 (2010).

¹⁸¹ See Sara Randazzo, *Companies Face Record Number of Shareholder Lawsuits*, Wall St. J., Aug. 22, 2017, available at <https://www.wsj.com/articles/why-lawsuits-targeting-stock-drops-are-on-the-rise-1503307800>.

¹⁸² See, e.g., Hal S. Scott and Leslie N. Silverman, *Stockholder Adoption of Mandatory Individual Arbitration for Stockholder Disputes*, 36 Harv. J. L. & Pub. Policy 1187, 1194 (2013).

Instead of focusing on the merits of the claims themselves, proponents of mandatory shareholder arbitration focus largely on the prosecution and significant recoveries for them. But the sizeable recoveries provide evidence that their fundamental contention that the claims are frivolous is false. On the contrary, the fact that private actions result in sizeable recoveries suggests that Congress' actions to ensure the private pursuit of only non-frivolous claims has had the expected effect of winnowing out smaller claims and increasing recoveries in cases that survive the considerable hurdles Congress has imposed.¹⁸³

Given this reality, it becomes clear that these commenters' objectives in pressing for arbitration is not simply to shift the venue in which such claims are brought, but precisely to limit the number of, and recoveries for, meritorious claims by investors. For example, in the mandatory arbitration proxy proposal to Alaska Air, the purported justification included a lengthy argument against the perceived abuses of class action litigation, followed by a clear statement of the purpose of the amendment:

Securities fraud class actions impose enormous costs on public companies while providing little benefit to shareholders¹⁸⁴ ... The only clear winners under this scheme are the lawyers who bring the suits and those who defend them, who profit handsomely from moving the money around. The proposed amendment would substantially reduce the incentive of plaintiffs lawyers to file suit against the Company in response to a drop in the Company's stock price.¹⁸⁵

The anti-class action advocates make little pretense of carefully evaluating the factual record. If they did, they would find what the experts who have done the analysis have found: there is little evidence to support their starting premise that litigation is causing companies to bear excessive costs for frivolous cases. As Professor Arthur Miller put it, "claims of excessive costs, abuse, and frivolousness in litigation may have much less substance than many think, and extortionate settlements may be but another urban legend."¹⁸⁶

Notably, under the heightened pleading standards for securities class actions, there are significant opportunities for companies to recover expenses or request the imposition of sanctions for frivolous suits. So, if there were a scourge of these suits being brought, companies and their legal counsel would have ample recourse. Yet, such actions are rare, despite the fact that Rule 11 determinations and sanctions for violations are mandatory since enactment of the PSLRA.¹⁸⁷

¹⁸³ See Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified at 15 U.S.C. §§ 78(a) et seq.); Pub. L. No. 105-353, 112 Stat. 3227 (1998).

¹⁸⁴ Facsimile from Steve Nieman to Karen Gruen, Alaska Air Group, at 14, Nov. 28, 2008, available at <https://www.sec.gov/Archives/edgar/vpr/0903/09038703.pdf>.

¹⁸⁵ *Id.*

¹⁸⁶ Arthur R. Miller, From Conley to Twombly to Iqbal: A Double Play on the Federal Rules of Civil Procedure, 60 DUKE L.J. 1, 103 (2010).

¹⁸⁷ Jerold S. Solovy, Norman, M. Hirsh, and Margaret J. Simpson, Sanctions Under Rule 11, Jenner & Block Practice Series, Jenner and Block LLP, available at https://jenner.com/system/assets/assets/5514/original/Sanctions_20Under_20Rule_2011-Complete_2010.pdf?1323114005 (PSLRA "changes the procedure for imposing Rule 11 sanctions and it makes sanctions mandatory, removing any discretion from the district courts." at 6. In addition, "A court may impose a Rule 11 sanction either on a party's motion or on the court's own initiative." at 125).

Nevertheless, to address the perceived “problem” of excessive costs from frivolous lawsuits, some have argued for the adoption of mandatory shareholder arbitration clauses, implemented through corporate bylaws and organizational documents. Moreover, as their arguments make clear, the primary objective is not simply to shift shareholder claims from judges to arbitrators, but to eliminate the claims entirely by undermining their economic viability.¹⁸⁸

Put another way, these commenters seem to be arguing for mandatory shareholder arbitration *precisely because it would be inadequate to protect the substantive rights at issue.*¹⁸⁹ In this way, their intent to limit private claims runs directly counter to the Supreme Court’s ruling in *McMahon* that arbitration would run afoul of the anti-waiver sections if it “weakens [investors’] ability to recover under the Exchange Act.”¹⁹⁰

Mandatory Shareholder Arbitration Clauses Would Undermine U.S. Capital Markets and Economic Competitiveness

In the decades since the federal securities laws were established, the capital markets of the United States have grown into the largest, most robust, and most envied in the world. Investors from around the world have flocked to invest in securities issued in the United States. In fact, as of June 2017, foreign investors held more than \$7.1 trillion in U.S. equity securities.¹⁹¹

Proponents of mandatory arbitration have argued that, while U.S. markets may attract investors, the threat of litigation drives away foreign listings. The opposite is true. Many companies from around the world have come to sell securities to investors here and see them listed on our world-leading exchanges.¹⁹²

As Ernst and Young put it in 2017, “Attracted to the stability and liquidity of US capital markets, foreign companies today overwhelmingly choose the US when they list outside of their home markets.”¹⁹³ It added: “For foreign

¹⁸⁸ *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U. S. 477, 481 (1989); Kagan, J., dissenting in *Italian Colors*; Facsimile from Steve Nieman to Karen Gruen, Alaska Air Group, at 14, Nov. 28, 2008, available at <https://www.sec.gov/Archives/edgar/vprr/0903/09038703.pdf>.

¹⁸⁹ See *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 228-229 (1987); *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U. S. 477, 481 (1989).

¹⁹⁰ *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 230 (1987).

¹⁹¹ Press Release, U.S. Dep’t of the Treasury, “Preliminary Report on Foreign Portfolio Holdings of U.S. Securities at End-June 2017,” (Feb. 28, 2018), available at <http://ticdata.treasury.gov/Publish/shlprelim.html>.

¹⁹² See, e.g., Alibaba IPO: The Biggest IPO in History, Alibaba, Lists on the NYSE, NYSE, available at <https://www.nyse.com/network/article/Alibaba-Lists-on-the-NYSE> (last visited July 2, 2018).

¹⁹³ Ernst and Young, *Looking behind the declining number of public companies: An analysis of trends in US capital markets*, May 2017, available at <https://www.ey.com/Publication/vwLUAssets/an-analysis-of-trends-in-the-us-capital-markets/%24FILE/ey-an-analysis-of-trends-in-the-us-capital-markets.pdf>.

companies choosing to execute a cross-border listing, the US is the favored market. From 2012 through 2016, the US was home to almost twice as many foreign IPOs as its closest competitor, the United Kingdom.”¹⁹⁴

U.S.-based companies are also choosing not to list elsewhere.¹⁹⁵ Contrary to predictions common in the years immediately following passage of the Sarbanes-Oxley Act, the United States is attracting more foreign issuers than any other country and is not losing U.S.-based companies to listings in other countries. Throughout this period, the SEC has not permitted U.S. public companies to adopt mandatory shareholder arbitration provisions in their bylaws or organizational documents. And, as the Petrobras case demonstrates, foreign companies that have adopted mandatory arbitration clauses are not protected against litigation by U.S. investors under federal securities laws. Clearly, the threat of litigation is not driving these companies away.

U.S. capital markets have comparatively high standards of integrity for corporate issuers as well as better oversight from regulators, and investors have comparatively greater rights to recover for frauds than in other systems.¹⁹⁶ Those have been features of our markets for decades, and they have served us well.

However, some would have the SEC and policymakers ignore this long record of success. Instead, they note that the majority of capital raises in the U.S. are no longer public offerings, but are instead private offerings. They note that, despite fewer investor protections in other countries, some American investors (and others around the world) may still invest abroad.¹⁹⁷

All of that may be true. However, none of these observations supports the conclusion that stripping away investor rights would impact any of those facts, much less somehow “fix” any perceived “problem.”

To the contrary, despite years of advocating this policy change, the proponents of mandatory shareholder arbitration for public companies have offered scant evidence to link their observations with their proposed solution. For example, to date, proponents of mandatory arbitration have offered no empirical evidence to show that their favored dispute resolution method would attract greater investment in the U.S. capital markets or improve investor returns. Nor have

¹⁹⁴ *Id.*

¹⁹⁵ *Id.*

¹⁹⁶ See, e.g., Andrew Beattie, *Alibaba IPO: Why List in the U.S.?*, Investopedia, available at <https://www.investopedia.com/articles/investing/112614/alibaba-ipo-why-list-us.asp> (“There is an element of prestige in being a NYSE listed company, but there is also a very practical advantage to listing in the United States. Companies trading publicly in the U.S. fall under the regulatory supervision of the SEC. Although this often means new processes and more paperwork for foreign companies making the leap, it pays off as investors see the increased scrutiny and transparency as a plus in the long run. If a company is listed in the U.S., it has the implicit SEC stamp of approval until some issue is exposed by the regulator. As a result, investors have more trust when reading the financials and making the investment. Whether this is entirely justified is another matter, but investors all over the world have been investing in U.S. stocks for decades.”).

¹⁹⁷ This argument seems particularly spurious, as its logic would demand that investors would find this issue solely dispositive. Investors make investment decisions, including what to buy and sell, and at what prices, based on a multitude of factors. Removing an important right will likely discourage investment, and may lead to lower investment prices or dollars invested, but may not stop an investment entirely.

they refuted evidence tying the success of U.S. markets in attracting foreign listings to the valuation premium and decreased cost of capital attributable to the higher level of public and private enforcement present in U.S. markets.

Instead, they have simply sought to disconnect the discussion of mandatory shareholder arbitration from one of the primary purposes of the securities laws themselves: deterring fraud. If they were to conduct a robust analysis, those advocating mandatory arbitration would have to identify and quantify the well-understood benefits of private litigation, as well as the loss of those benefits for market participants and the whole economy. They would, at a minimum, need to consider the macroeconomic harms imposed upon the entire economy when securities fraud becomes pervasive in financial markets.¹⁹⁸

In reality, investors come to the United States precisely because we have higher-quality investment opportunities, greater oversight, and greater investor rights. Issuers come here because that's where the investors are.

Any Actions to Permit Mandatory Shareholder Arbitration Must Comply with the Law, including the APA and the Federal Securities Law

In early 2018, it was reported that the SEC might reconsider its longstanding opposition to mandatory shareholder arbitration.¹⁹⁹ There are many potential avenues in which this issue could come before the Commission, only some of which may be driven by the SEC itself.

The agency could begin a rulemaking process, either in response to Congressional direction or on its own volition. If this were to occur, the agency would be clearly bound to follow both the Administrative Procedure Act and its own procedural rulemaking requirements, such as considering all appropriate costs and benefits and engaging in a robust economic analysis. This would likely have to include a clear identification and quantification of the “problem” the SEC would seek to address, and the costs and benefits of the “solution,” as well as other potential — less draconian — “solutions.” The Commission would presumably also have to identify and seek to quantify the larger impacts on market integrity and investment.

¹⁹⁸ See Steven A. Ramirez, *The Virtues of Private Securities Litigation: An Historic and Macroeconomic Perspective*, 45 *Loyola U. Chi. L.J.* 669 (2014), available at <https://lawcommons.luc.edu/cgi/viewcontent.cgi?article=1475&context=luclj>.

¹⁹⁹ Benjamin Bain, *SEC Weighs a Big Gift to Companies: Blocking Investor Lawsuits*, *Bloomberg* (Jan. 26, 2018), available at <https://www.bloomberg.com/news/articles/2018-01-26/trump-s-sec-mulls-big-gift-to-companies-blocking-investor-suits>.

An SEC rulemaking that wasn't specifically authorized by Congress would be particularly vulnerable to challenge in light of the SEC's past record finding mandatory arbitration agreements to be a violation of securities law and long-standing congressional opposition to policies that would eliminate private class action lawsuits.

But formal rulemaking is not the only avenue through which the issue might arise. The SEC could also be forced to address the issue, as it has in the past, by actions of private parties. For example, as occurred with Carlyle, mandatory shareholder arbitration could come before the SEC in the context of a new public offering.²⁰⁰ If this happened, the SEC would be afforded a clear opportunity to act, as it ostensibly controls the fate of the effectiveness of the registration statement. And we would expect it to take the same action as it has in the past and decline to accelerate the effectiveness of a registration statement that would include reference to mandatory shareholder arbitration. In doing so, it could and should simply affirm its past findings that the provisions violate securities laws.

The issue could similarly arise as it did with Alaska Air,²⁰¹ Gannett,²⁰² and Pfizer,²⁰³ as a shareholder proposal of an already-public company for the company to amend its bylaws and organizational documents to include mandatory shareholder arbitration. Again, if the company opted to exclude the proposal from proxy materials, the SEC could and should resolve the issue as it has in the past.

But if the matter comes before the SEC in other ways, the SEC may not have such a clear path to block or permit the action. For example, what if a private company that already has such a clause were to trigger Exchange Act reporting thresholds? Similarly, what if an already public company simply amends its bylaws and organizational documents to provide for mandatory shareholder arbitration?²⁰⁴ The SEC could undoubtedly take action if it continues its view that these actions would be contrary to the law and public policy, but this would essentially force the SEC to take dramatic action after the fact.

²⁰⁰ See, e.g., S-1/A, The Carlyle Group L.P., Jan. 10, 2012, *available at* <https://www.sec.gov/Archives/edgar/data/1527166/000095012312000638/w83442a2sv1za.htm>.

²⁰¹ Facsimile from Steve Nieman to Karen Gruen, Alaska Air Group, at 15, Nov. 28, 2008, *available at* <https://www.sec.gov/Archives/edgar/vpr/0903/09038703.pdf>.

²⁰² Letter from Donald Vuchetich and Susan Vuchetich to Gannett Co. Inc., Nov. 11, 2011, *available at* <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2012/2donaldvuchetich022212-14a8.pdf>.

²⁰³ *Id.*

²⁰⁴ As previously described, some publicly traded investment vehicles (such as REITs) have adopted bylaws with purportedly sweeping language requiring mandatory shareholder arbitration. See, e.g., Equity Commonwealth, 2017 10-K, at 17 ("Shareholder litigation against us or our Trustees and officers may be referred to binding arbitration proceedings which may increase our risk of default. Our bylaws provide that actions by our shareholders against us or against our Trustees and officers, including derivative and class actions, may be referred to binding arbitration proceedings. As a result, our shareholders would not be able to pursue litigation for these disputes in courts against us or our Trustees and officers if the disputes were referred to arbitration. In addition, the ability to collect attorneys' fees or other damages may be limited, which may discourage attorneys from agreeing to represent parties wishing to commence such a proceeding."). To date, we are unaware of any operational company engaging in the same strategy. For the reasons articulated in this report, we urge the SEC to take action to suspend or revoke the public trading rights in these securities, as contrary to the law and public policy.

Given the tantalizing potential for corporate issuers to eliminate risk of securities class actions, we view it as highly likely that mandatory shareholder arbitration will come before the SEC within the next several years. Regardless of the manner in which this issue arises, however, the agency must “examine the relevant data and articulate a satisfactory explanation for its action, including a rational connection between the facts found and the choices made.”²⁰⁵ Failure to do so would be arbitrary and capricious, and the Supreme Court has ruled that it will set aside agency action that is “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.”²⁰⁶

As Gannett’s legal counsel implored in its no-action relief request over six years ago, if the matter of mandatory arbitration is to be taken up, “the appropriate course of action is for the issue to be debated and decided by Congress, through amendment to the Exchange Act, or by the Commission, through the appropriate rulemaking process pursuant to the same and under the Securities Act of 1933, as amended.”²⁰⁷ Were the SEC to take another approach, we might expect significant litigation against both the company or companies involved and the SEC itself.

Additional Considerations for Companies and Other Stakeholders

If, despite all the evidence against it, the SEC were to suddenly permit mandatory shareholder arbitration, there would still be a number of significant and complex state and federal law issues impacting affected companies, investors, brokers, exchanges, and other stakeholders. While there are hundreds of potentially complex issues that could arise, implicating both state and federal law, we highlight just a few below. Notably, there are issues that would arise in two distinct stages: (1) while adopting a mandatory shareholder arbitration provision or going public, and (2) during and after each arbitration brought thereafter.

As an example of the first category of potential issues, assume a public company without a mandatory shareholder arbitration provision changes its bylaws to adopt such language. There may be investors who bought the securities before the severe limitation in their rights for recovery were adopted. Further, these investors may have little or no power to influence the decision to change the company’s bylaws to provide for such limitations. Would this change

²⁰⁵ *Business Roundtable v. SEC*, No. 10-1305, slip op. (D.C. Cir. July 22, 2011) (citing *Motor Vehicle Mfrs. Ass’n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (internal quotation marks omitted)).

²⁰⁶ *Business Roundtable v. SEC*, No. 10-1305, slip op. (D.C. Cir. July 22, 2011) (citing 5 U.S.C. § 706(2)(A)).

²⁰⁷ Letter from Kevin L. Vold, Counsel for Gannett, to Office of Chief Counsel, Division of Corp. Finance, SEC, at 2, Dec. 27, 2011, available at <https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2012/2donaldvuchetich022212-14a8.pdf>.

create legal liability risks to the company that might implement such a provision? If so, how?

Would the investors have adequate notice of the change? The change itself may impact the stock's value (as it would be a material change to the rights of investors). Would that change create any liability risks? Would or could the disclosures be adequate? Would investors with fiduciary duties to their underlying customers be willing to invest in securities with such limited rights for recovery? Would investments in companies with mandatory shareholder arbitration be viewed as "suitable" for ordinary, "retail" investors, despite the limited rights? Would mandatory shareholder arbitration clauses in public companies be consistent with U.S. exchange listing standards? Would mandatory shareholder arbitration clauses, or the process utilized to adopt them, comply with state laws and registration requirements?

If a company were to adopt a mandatory arbitration clause, and then engage in arbitration, how could this impact its disclosure processes? For example, would the existence of the arbitration itself create material, non-public information? And if it could, how would that be managed? These issues may quickly become remarkably complex, as some key shareholders bringing claims would have greater information than others. For example, would a company be willing to overpay one investor in an arbitration to keep that claimant quiet as to an issue that could be pursued by other potential claimants? If so, what are the implications for the company and its disclosures? What role would the SEC have in ensuring that the claimants' rights under the federal securities laws are appropriately enforced through the arbitration process?

Thus, even if the SEC were to take action to permit mandatory arbitration, in contravention of its own past findings and clear congressional intent, there would still be significant legal and regulatory risks associated with the potential adoption of mandatory shareholder arbitration clauses in public companies' bylaws and organizational documents. To date, we have seen almost no detailed analyses of these issues.

Conclusion

The U.S. capital markets are the largest and most robust in the world. Some of the primary advantages of our markets are the high-quality investment opportunities and strong investor protections they offer. These advantages have been achieved, in large part, by the dual enforcement regime of both government action and private lawsuits. Both enforcement mechanisms are essential to providing investors with adequate means to recover losses and deterring misconduct. Mandatory shareholder arbitration would undermine both of these objectives, and particularly the deterrence of misconduct, an

essential element to ensuring the integrity of U.S. capital markets on which the health of our economy depends.

Over the past several decades, the SEC has on several occasions been asked to permit mandatory shareholder arbitration, despite the fact that it would unquestionably weaken the ability of investors to directly recover for losses and deter misconduct. The SEC may soon be asked to decide this issue yet again. We expect it to continue to follow the law and policy that has served the U.S. capital markets and investors so well for over eighty years, and continue to reject mandatory shareholder arbitration as inconsistent with its core mission to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation.

