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COMMENT

PREDISPUTE ARBITRATION CLAUSES IN A BROKERAGE FIRM'S CUSTOMER ACCOUNT AGREEMENT


I must say that, as a litigant, I should dread a lawsuit beyond almost anything else short of sickness and death.¹

INTRODUCTION

In recent years, the public has become more involved in the securities markets.² This involvement has led to more disputes between the public and members of the securities industry.³ Thus, investors have become more cautious in where they put their money, and to whom they give their money.⁴ Securities arbitration disputes typically involve allegations of excessive trading, churning, unauthorized trades, unsuitable investments, or failure to execute trades.⁵

Investors are increasingly choosing arbitration over litigation as

³ Id.
⁵ McMurray, Arbitration Can be Better Than Litigation When Investors and Brokers Don't Agree, Wall St. J., Apr. 30, 1986, at 55, col. 4. These illegal techniques give rise to causes of action under the federal securities laws. See infra notes 28-50 and accompanying text.
the forum for their dispute resolution. Achieving justice between the parties is the purpose of arbitration. Its function is to achieve a final resolution of the dispute in an easier, more expeditious and less expensive manner than litigation. Consequently, it is a preferential method of settling disputes.

For many years, brokerage houses have included arbitration clauses in their customer account agreements. In 1953, however, the United States Supreme Court expressly refused to enforce such agreements in Wilko v. Swan. The Wilko Court's reasoning was based upon certain sections of the Securities Act of 1933. Yet, the Wilko Court's ruling seemed to belie the intent and application of the Federal Arbitration Act (FAA). Thirty-five years later, in Shearson/American Express, Inc. v. McMahon, the United States Supreme Court's interpretation of the federal

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Court affirmatively embraced the arbitration of securities disputes brought under the Securities Exchange Act of 1934.14

This Comment advocates the overruling of the *Wilko* doctrine. The Comment's organizational structure is divided into four parts. First, a general introduction to the relevant statutory framework that applies to securities arbitration disputes is discussed. Second, an overview of the benchmark Supreme Court cases that have addressed securities arbitration disputes is given. Third, a detailed examination of the effects of the *McMahon* decision is provided. Fourth, an examination of the effects of *McMahon* leads to the conclusion that the *Wilko* doctrine should be overruled.

I. THE RELEVANT STATUTORY FRAMEWORK

   A. The Federal Arbitration Act of 1925

   American courts have frequently either refused recognition of arbitration agreements or openly denied enforcement of agreements that expressly chose arbitration as the forum for dispute resolution.15 In response to this nonrecognition, Congress enacted the Federal Arbitration Act.16 The purpose of the FAA was to deliberately alter the judicial atmosphere previously existing in regard to arbitration agreements.17 The congressional committee that adopted the FAA stated:

   Arbitration agreements are purely matters of contract, and the effect of the bill is simply to make the contracting party live up to his agreement. He can no longer refuse to perform his contract when it becomes disadvantageous to him. An arbitration agreement is placed upon the same footing as other contracts, where it belongs.18

   By enacting the FAA Congress resolved two issues. The first issue concerned a lack of an expressed congressional intent advocating arbitration in this country. Second, a major policy consideration of the Act was attempting to relieve congestion in the courts by providing parties "with an alternative method for dispute resolution that would

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14. *Id.* at 2341-43.
17. *H.R. REP. No. 96, 68th Cong., 1st Sess., 1-2 (1924).*
18. *Id.* at 1-2.
be speedier and less costly than litigation."  

Recent court decisions have amplified the full intent and focus of the FAA. In fact, courts have judicially recognized that there exists a "national policy favoring arbitration." This policy has led courts to recognize the strong congressional intent favoring arbitration agreements. Subsequently, the Supreme Court has declared that it will rigorously enforce agreements to arbitrate. Thus, the intent and scope of enforceability of the FAA is now generally immune from adverse judicial scrutiny.

Upon enacting the FAA, Congress mandated the enforcement of arbitration agreements. The pertinent sections of the FAA that bear upon predispute arbitration agreements are sections two and three. Section two provides that any contract involving commerce that has an agreement to arbitrate shall "be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." Section three mandates a stay of proceeding upon the trial court where any issue before the trial court is referable to arbitration. Therefore, Congress, by enacting the FAA, placed the judiciary on notice that arbitration agreements de-

21. Id. at 10.
23. Id.
24. See generally Sterk, supra note 7, at 482-92.
25. 9 U.S.C. § 2 (1982)(emphasis added). This section provides:
A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.
Id.
26. 9 U.S.C. § 3 (1982) provides:
If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.
Id.
serve equal treatment as would any other agreement under the law of contracts.

B. The Securities Act of 1933

The American stock market crashed in 1929. Because of the cataclysmic effect upon the nation, the President urged Congress to enact legislation that would promise better investor protection. In 1933, Congress recognized the hazards of unequal bargaining positions between those inside the securities industry and the outside investor.27 The congressional response was to enact the Securities Act of 1933.28 The Securities Act requires the registration of securities publicly offered by a company or persons controlling a company. The Act requires the use of a prospectus that provides for full disclosure of complete, material information in connection with public offerings.29 It also regulates fraud in connection with the sale of such securities.30

Predispute arbitration agreements apply to three sections of the Securities Act. First, section 12(2) imposes liability upon a seller of securities who provides information that is "untrue" or not fully disclosed to a securities buyer.31 Second, section 14 provides that no party may waive any binding condition, stipulation, or provision that is codified within the Securities Act or the rules and regulations of the Commission.32 Third, section 22(a) bestows the federal district

29. See id. §§ 77j, 77k (1982).
30. Id. §§ 77a-77aa.
Any person who — . . .
(2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.
Id.
courts with jurisdiction over offenses and violations under the Act.\(^{33}\)

C. The Securities Exchange Act of 1934

Congressional anxiety concerning the securities industry was not relieved by the enactment of the Securities Act of 1933. In 1934, Congress enacted further legislation that addressed additional requirements for the disclosure of information.\(^{34}\) The Securities Exchange Act of 1934 Exchange Act requires the registration of securities prior to listing and trading on an exchange, as well as the registration of over-the-counter securities in which there is significant trading interest.\(^{35}\)

The Exchange Act requires the registration of broker-dealers, national securities exchanges, and associations of securities dealers with the Securities and Exchange Commission. The Exchange Act also regulates fraud and manipulation of the purchase or sale of securities, and generally regulates the trading markets in securities.\(^{36}\) The Exchange Act was passed to insure the protection of investors "against the manipulation of stock prices through regulation of transactions consummated upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on those companies which have stock listed on national securities exchanges."\(^{37}\)

Predispute arbitration agreements apply to two sections of the Exchange Act. First, section 10(b) makes it unlawful for any seller of securities to "employ . . . any manipulative or deceptive device [in] . . . connection with the purchase or sale of any security."\(^{38}\) Second,

Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void.

\textit{Id.} (emphasis added).

\(^{33}\) 15 U.S.C. § 77v(a) (1986) provides:

The district courts of the United States, and the United States courts of any Territory, shall have jurisdiction of offenses and violations under this subchapter and under the rules and regulations promulgated by the Commission in respect thereto, and, concurrent with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by this subchapter . . .

\textit{Id.}

For a discussion addressing the relationship between these statutory sections, see \textit{infra} notes 56-58 and accompanying text.


\(^{36}\) \textit{Id.}

\(^{37}\) \textit{Id.}

\(^{38}\) 15 U.S.C. § 78j(b) (1982) states:

\begin{itemize}
  \item It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
  \item To use or employ, in connection with the purchase or sale of any
\end{itemize}
section 29(a) provides that no party may waive any binding condition, stipulation or provision that is codified within the Exchange Act, the rules or regulations thereunder or any required rule of exchange.\textsuperscript{39} Section 29(a) is equivalent to section 4 of the Securities Act.\textsuperscript{40}

Despite the limiting language expressed in several sections of each Act, courts have generally construed the Securities Act and the Exchange Act \textit{in pari materia} as a single comprehensive regulatory scheme.\textsuperscript{41} However, these acts do not overlap completely, and certain rights may be available under one Act but not under the other.\textsuperscript{42}

\textbf{D. The Securities and Exchange Commission}

To facilitate the implementation of the rules and regulations codified by both the Securities Act and the Exchange Act, Congress created the Securities and Exchange Commission (SEC).\textsuperscript{43} The SEC is an independent regulatory agency that enforces the federal securities laws by conducting investigations which may lead to criminal prosecutions, civil actions for injunctive relief, or to administrative proceedings that impose remedial sanctions on broker-dealers and investment advisors.\textsuperscript{44}
Additionally, the SEC’s staff processes the numerous filings required under the federal securities laws, including securities registration under the Securities Act. The SEC has extensive rule-making authority granted by specific provisions, such as section 10(b) of the Exchange Act, as well as general rule-making authority.\(^4\)\(^5\)

Congress has given the SEC extensive oversight authority over self-regulatory organizations and broker-dealers.\(^4\)\(^6\) The SEC has specifically “followed” complaints made against broker-dealers and their employees.\(^4\)\(^7\) Remaining responsibilities include overseeing and regulation of the activities of stock exchanges and securities associations, including the rules that the exchanges and associations prescribe upon their members.\(^4\)\(^8\)

Utilizing its quasi-legislative powers, the SEC has set forth Rule 10b-5.\(^4\)\(^9\) This rule, as a complement to the Exchange Act’s section 10(b), declares that it shall be unlawful for any person to “employ any device, scheme, or artifice to defraud . . . a person ‘in connection with the purchases or sale of any security.’”\(^5\)\(^0\) The disclosure and antiwaiver provisions of the Securities Act, Exchange Act and Rule 10b-5 were designed to protect the small investor. These enactments prohibit those on the “inside” from taking advantage of their superior knowledge to profit at the expense of stockholders or the investing public.\(^5\)\(^1\)

\(^4\)\(^5\). Id.

\(^4\)\(^6\). See H. Blumenthal, Securities Law Handbook, § 1.02 (1987-88 ed.) (comprehensive description of a Self-Regulatory Organization (SRO)); id. at § 22.01 (comprehensive description of a broker-dealer).


\(^4\)\(^8\). H. Blumenthal, supra note 35; see, e.g., 15 U.S.C. §§ 77h, 77s, 77t (1982); id., § 78a, 78i, 78s.


\(^4\)\(^9\). Rule 10b-5 is codified at 17 C.F.R. § 240.10b-5 (1986).

\(^5\)\(^0\). 17 C.F.R. § 240.10b-5 (1986) provides in its entirety:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

II. RELEVANT CASE LAW — INTERPRETATIONAL ISSUES ARISE

A. Wilko v. Swan: The Wilko Doctrine Emerges

In the case of *Wilko v. Swan*, a customer charged his broker with a violation of section 12(2) of the Securities Act. Without answering the complaint, the broker moved to stay the trial of the action pursuant to section 3 of the FAA, in accordance with the terms of their margin account agreement.

The Supreme Court ruled that section 12(2) created "a special right to recover for misrepresentation which differs substantially from the common-law action in that the seller is made to assume the burden of proving lack of scienter." The crux of the Court's decision was not based upon section 12(2), but rather upon section 14 of the Securities Act. The Court reasoned that section 14 maintains that an arbitration agreement is a "stipulation" and, thus, the right to select a judicial forum is the kind of "provision" that cannot be waived.

Although the Court did recognize the desirability of arbitration as evinced by the passage of the FAA, it perceived the congressional

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52. 346 U.S. 427 (1953).
53. Id. at 428. The customer alleged that the broker falsely represented the value of the purchased stock and purposely omitted information concerning the stock. Id. at 429; see also supra note 31.
54. Wilko, 346 U.S. at 428; see supra note 26.
55. Wilko, 346 U.S. at 429-30. A "margin account" is established when the broker extends credit to the customer for a portion of the purchase price and holds the customer's securities as collateral for the loan. This is compared with a "cash account" where the customer is obligated to make full payment in cash for any securities that are purchased. D. Ratner, Securities Regulation — Materials for a Basic Course (2d ed. 1980).

The customer account agreement in *Wilko* stated:

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

*Wilko*, 346 U.S. at 432 n.15.


58. Id. at 434-35.
intent of the FAA as simply an alternative to the complications of litigation.\textsuperscript{59} The Court interpreted Congress' intent as a favorable attitude toward arbitration,\textsuperscript{60} stating that the Securities Act was crafted "with an eye to the disadvantages under which buyers labor."\textsuperscript{61}

The Court further stated that a buyer would surrender one of the advantages the Act gives him upon agreeing to arbitrate any dispute.\textsuperscript{62} Therefore, the Court ruled that "the intention of Congress concerning the sale of securities is better carried out by holding invalid such an agreement for arbitration of issues arising under the Act."\textsuperscript{63} Thus, the customer's advance agreement to arbitrate disputes subsequently arising out of his contract to purchase the securities was unenforceable under the language of section 14 of the Securities Act.

The result of the \textit{Wilko} decision was to indoctrinate the belief that the Securities Act created a special right of a private remedy for civil liability. Thus, an exception to the clear provisions of the FAA was created.

\textbf{B. Scherk v. Alberto-Culver Company: A "Colorable Argument" Appears}

In the interim between \textit{Wilko} and \textit{Scherk v. Alberto-Culver Co.},\textsuperscript{64} federal courts began to utilize the \textit{Wilko} doctrine in disputes involving the Exchange Act of 1934.\textsuperscript{65} The federal courts' view was that the \textit{Wilko} doctrine was also logically applicable to disputes involving section 10(b) of the Exchange Act and Rule 10b-5 as well.\textsuperscript{66} The \textit{Scherk} decision addressed that particular usage of the \textit{Wilko} doctrine.

In \textit{Scherk}, Alberto-Culver, an American company, commenced an action for damages and other relief contending that Mr. Scherk fraudulently represented the status of certain trademark rights.\textsuperscript{67} Alberto-Culver alleged that the misrepresentations violated section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5.

\textsuperscript{59} \textit{Id.} at 431-32.
\textsuperscript{60} \textit{Id.} at 432.
\textsuperscript{61} \textit{Id.} at 435.
\textsuperscript{62} \textit{Id.}
\textsuperscript{63} \textit{Id.} at 438.
\textsuperscript{64} 417 U.S. 506 (1974).
\textsuperscript{66} \textit{See Scherk}, 417 U.S. at 513-14.
\textsuperscript{67} \textit{Id.} at 509.
promulgated by the SEC. The Court’s ruling in the Scherk case was predominantly based upon the importance and nature of international transactions. The majority opinion by Justice Stewart addressed a colorable argument concerning section 10(b) and Rule 10b-5.

Justice Stewart stated that “[a]t the outset, a colorable argument could be made that even the semantic reasoning of the Wilko opinion does not control the case before us.” Justice Stewart’s assertion, although obiter dictum, can be presented in four parts: (1) there was not an express statutory counterpart in section 12(2) in the Exchange Act; (2) neither section 10(b) nor Rule 10b-5 speaks of a private remedy to redress violations of the kind alleged in Scherk; (3) though courts had recognized a section 10(b) private right of action, the Exchange Act, itself, does not establish the special right that the Court in Wilko found significant; and (4) the jurisdiction provision of the Securities Act, section 22(a), provided for concurrent state and federal forums, whereas the parallel section of the Exchange Act, section 27, provided for exclusive federal jurisdiction. Justice Stewart stated that this contrast demonstrated a more restricted jurisdiction. But, because the Court ultimately decided the finality of the Scherk dispute upon the international elements of the case and the effects therein, the colorable argument of Mr. Justice Stewart remained untested.

C. Dean Witter Reynolds, Inc. v. Byrd: The “Colorable Argument” Reappears

The interlude between Scherk and Dean Witter Reynolds, Inc. v. Byrd was not untroubled on the federal circuit court level. A split

68. Id.; see supra notes 38, 50 (discussing liability for misrepresentations under section 10(b) and Rule 10b-5).

69. Id. at 513.

70. Id.

71. Id. at 514.

72. 470 U.S. 213 (1985). Upon the enactment of the FAA, all state courts became bound to the FAA under the Supremacy Clause of the United States Constitution. See U.S. Const. art. VI.
occurred concerning the treatment of complaints that alleged both federal securities claims and pendent state claims. The holdings of the various circuit courts began to follow one of two lines of interpretational thought. One viewpoint, supported by the Fifth, Ninth, and Eleventh Circuits, relied on an approach known as the "interwining doctrine." 73 The other viewpoint, adopted by the Sixth, Seventh, and Eighth Circuits, held that to "bifurcate" the pendent claims from the federal claims was proper concerning arbitrable claims. 74

In Byrd, a customer filed an action in federal district court alleging violations of the Exchange Act and of various state law provisions. 75 The parties had a written agreement to arbitrate any dispute that might arise out of the account. 76 Dean Witter Reynolds did not, however, attempt to assert that section 10(b) claims are arbitrable under the FAA. 77 As a result, the Court did not address that issue. Nevertheless, Justice White's concurring opinion readdressed the arbitration issue. Justice White's dictum addressed two issues that he felt were left undeveloped in the Byrd decision. 78 He stated that the nonarbitrability status of claims under the Exchange Act was a matter of substantial doubt. 79 Justice White said that the Wilko decision was premised upon the interconnection of sections 12(2), 14, and 22 of the Securities Act. 80 He declared that "Wilko's reasoning cannot
be mechanically transplanted to the [Exchange Act].”

Justice White’s reasoning was that although section 29 of the Exchange Act is equivalent to section 14 of the Securities Act, the counterparts of the Securities Act (12(2) and 22) are imperfect, or absent altogether. Justice White recognized that causes of action under section 10(b) and Rule 10b-5 concerning arbitration were implied rather than express. He said, “I reiterate [those reservations concerning the Exchange Act] to emphasize that the question remains open and the contrary holdings of the lower courts must be viewed with some doubt.” Justice White’s concurrence set the stage for the Supreme Court to rule on the arbitrability of claims brought under the Exchange Act.

D. Shearson/American Express, Inc. v. McMahon: The “Colorable Argument” Comes of Age

Despite the admonitions of Justice Stewart and Justice White in Scherker and Byrd, the majority of the federal appellate courts continued to rule that claims brought under the Exchange Act were not arbitrable. However, two federal circuit courts broke rank and began to rule that such claims were, in fact, arbitrable.

It was the United States Court of Appeals for the Second Circuit that first addressed the arbitrability or nonarbitrability of claims brought under the Exchange Act after the Byrd decision. In McMahon v. Shearson/American Express, Inc., the Second Circuit reversed the district court and endorsed the customer’s contention that section 10(b) and Rule 10b-5 claims were not arbitrable. The court refused to overrule this precedent based only upon the defendant’s speculation as to what the Supreme Court may do with what had previously been settled law.

The United States Court of Appeals for the Eighth Circuit, how-

81. Id.
82. Id.
83. Id. at 225.
84. Id.
85. See, e.g., Sterne v. Dean Witter Reynolds, Inc., 808 F.2d 480, 483 (6th Cir. 1987); Jacobson v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 797 F.2d 1197, 1202 (3d Cir. 1986); King v. Drexel Burnham Lambert Inc., 796 F.2d 59, 60 (5th Cir. 1986).
87. 788 F.2d 94 (2d Cir. 1986).
88. Id. at 99.
89. Id. at 97; see Note, Arbitrability of Claims Arising Under the Securities Exchange Act of 1934, 1986 DUKE L.J. 548, 564 (1986) (citing Shearson/American Express, Inc. v. McMahon, 788 F.2d 94 (2d Cir. 1986)).
ever, rejected the Second Circuit's lead and was the first federal court of appeals after the Byrd decision to rule that arbitration agreements are enforceable with regard to claims arising under the Exchange Act. The United States Court of Appeals for the First Circuit soon joined the Eighth Circuit's decision. Thus, these discordant holdings induced Shearson/American Express to file a petition for certiorari with the Supreme Court of the United States. Justice Stewart's colorable argument could now be put to the test.

In Shearson/American Express, Inc. v. McMahon, McMahon, a brokerage firm customer, filed suit against his broker alleging violations of the antifraud provisions in section 10(b) of the Securities Exchange Act of 1934 and of the SEC promulgated rule 10b-5. Specifically, McMahon alleged that the broker engaged in fraudulent, excessive trading, made false statements and omitted material facts from the advice given to him. Two customer agreements were signed that provided for arbitration of any controversy relating to the accounts that were maintained with the broker. Pursuant to their agreement, Shearson/American Express moved to compel arbitration of McMahon's claims in accordance with section 3 of the FAA.

The Supreme Court premised its holding by first discussing the FAA and the FAA's intent. The Court stated that "[t]he Act was intended to 'reverse[e] centuries of judicial hostility to arbitration agreements' by 'placing arbitration agreements upon the same footing as other contracts.' " The Court held that the means to the mentioned ends are accomplished through section 2 of the FAA, which provides that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." Thus, concluded the Court, the FAA firmly establishes a federal arbitration policy that re-

90. Phillips, 795 F.2d at 1399.
91. Page, 806 F.2d at 296-98.
94. Id. at 2336.
95. Id. at 2335. The agreement signed by Mr. McMahon stated:
   "Unless unenforceable due to federal or state law, any controversy arising out of or relating to my accounts, to transactions with you for me or this agreement or the breach thereof, shall be settled by arbitration in accordance with the rules, then in effect, of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc., and/or the American Stock Exchange, Inc. as I may elect.
Id. at 2335-36.
96. Id. at 2336; see supra note 26 and accompanying text.
99. McMahon, 107 S. Ct. at 2337; see supra note 25 and accompanying text.
quires rigorous enforcement of agreements to arbitrate.\textsuperscript{100} Therefore, the FAA, standing alone, mandates enforcement of agreements to arbitrate statutory claims.\textsuperscript{101}

The Court charted its decision in three sections. Each section was correlated to the three-part argument presented by McMahon. McMahon's argument stated that section 29(a) forbids waiver of section 27 of the Exchange Act of 1934.\textsuperscript{102} The Court rejected this contention.\textsuperscript{103} The Court said that the language of section 29 did not reach so far.\textsuperscript{104} The Court stated that section 29(a) forbade the waiver of compliance with the provisions of the statute, but, "[b]ecause section 27 does not impose any statutory duties, its waiver does not constitute a waiver of 'compliance with any provision' of the Exchange Act under § 29(a)."\textsuperscript{105} Thus, the Court ruled that section 29(a) does not forbid waiver of section 27 of the Exchange Act of 1934.\textsuperscript{106}

McMahon next contended that arbitration agreements effected an impermissible waiver of the substantive protections of the Exchange Act.\textsuperscript{107} The Court analyzed the composition of this argument in two parts. First, the Court addressed McMahon's contention that predispute agreements are void under section 29(a) because they tend to result from broker overreaching.\textsuperscript{108} The Court refused to adopt what it called such an unlikely interpretation of section 29(a).\textsuperscript{109} McMahon's second sub-argument was that arbitration itself weakens the ability to recover under the Exchange Act.\textsuperscript{110} The Court noted that this argument was at the heart of the Court's decision in \textit{Wilko},\textsuperscript{111} and McMahon was urging that the Court should follow its reasoning.\textsuperscript{112}

The Court, however, stated that the reasons given in \textit{Wilko} reflected a general suspicion of the desirability of arbitration and the competence of arbitral tribunals.\textsuperscript{113} "It is difficult to reconcile \textit{Wilko}'s mistrust of the arbitral process with this Court's subsequent decisions involving the Arbitration Act."\textsuperscript{114} The Court further stated that because mistrust of arbitration was the basis for the \textit{Wilko}\textsuperscript{115}

\begin{thebibliography}{11}
\bibitem{100} McMahon, 107 S. Ct. at 2337.
\bibitem{101} Id.
\bibitem{102} Id. at 2338; see supra note 39.
\bibitem{103} McMahon, 107 S. Ct. at 2338.
\bibitem{104} Id.
\bibitem{105} Id.
\bibitem{106} Id.
\bibitem{107} Id. at 2339.
\bibitem{108} Id.
\bibitem{109} Id.
\bibitem{110} Id. at 2339-40.
\bibitem{111} Id. at 2340.
\bibitem{112} Id.
\bibitem{113} Id.
\bibitem{114} Id.
\end{thebibliography}
decision, the assessment of arbitration at the present time did not square with those assessments made in 1953. Therefore, the Court concluded that an arbitration agreement does not effect a waiver of the substantive protections of the Exchange Act.

The final argument presented by McMahon was that even if section 29(a) as enacted did not void predispute arbitration agreements, Congress had subsequently indicated its desire for such an interpretation of section 29(a). The thrust of this contention was that in 1975, Congress enacted amendments to the Exchange Act which did not address the general question of arbitrability of Exchange Act claims.

This argument was based solely on a sentence from a congressional conference report. McMahon contended that the report amounted to ratification of the Wilko doctrine as broadened to cover Exchange Act claims. The Court found this argument "fraught with difficulties." The Court stated that "[w]e cannot see how Congress could extend Wilko to the Exchange Act without enacting into law any provision remotely addressing that subject." Thus, the Court concluded that Congress did not expressly intend for section 29(a) to bar the enforcement of all predispute arbitration agreements.

In summary, the Court expressly held that: (1) the waiver of section 27 does not constitute a waiver of compliance with any provision of the Exchange Act under section 29; (2) the assessment of arbitration, at the present time, does not square with those assessments made at the time of the Wilko decision; hence, an agreement to arbitrate does not effect a waiver of the protections of the Exchange Act; and (3) Congress did not ratify, explicitly or implicitly, the Wilko doctrine in its extensive revisions of the Exchange Act in 1975. Accordingly, the Supreme Court reversed the judgment of the Court of

115. Id. at 2341.
116. Id.
117. Id. at 2342.
118. Id.
119. Id. The conference report states:

The Senate bill amended section 28 of the Securities Exchange Act of 1934 with respect to arbitration proceedings between self-regulatory organizations . . . . The House amendment contained no comparable provision . . . . It was the clear understanding of the conferees that this amendment did not change existing law as articulated in Wilko v. Swan, concerning the effect of arbitration proceedings provisions in agreements entered into by persons dealing with members and participants of self-regulatory organizations.

120. McMahon, 107 S. Ct. at 2342-43.
121. Id. at 2343.
122. Id.
123. Id.
Appeals for the Second Circuit and remanded the case for further proceedings consistent with their opinion. At long last, Justice Stewart's colorable argument had seasoned.

V. POST-MCMAHON EFFECTS

A. Federal Courts Cast Off McMahon-Type Cases

As a result of the McMahon decision, numerous federal securities cases were crucially affected. The Supreme Court immediately denied certiorari to all cases that brought forth Exchange Act and RICO claims which specifically addressed arbitration agreements. Virtually every federal circuit court contemporaneously dismissed all cases which directly addressed the McMahon issues. Several courts ruled that McMahon was intended to be retroactively applied.

B. The Securities and Exchange Commission Reaction

The SEC was affected in two ways by McMahon. First, the SEC intensified its review of SRO arbitration programs. Second, the McMahon ruling prompted the SEC to reconsider its Rule 15c2-2, which conflicted with the McMahon decision. Thereafter, because of the inappropriateness of Rule 15c2-2 in light of the McMahon decision, the SEC rescinded the rule. The rescission of Rule 15c2-2

124. Id. at 2346.


126. E.g., Noble v. Drexel Burnham Lambert, Inc., 823 F.2d 849 (5th Cir. 1987); Nesslage v. York Securities, Inc., 823 F.2d 231 (8th Cir. 1987); Wolfe v. E.F. Hutton & Co., Inc., 800 F.2d 1032 (11th Cir. 1986); Badart v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 797 F.2d 775 (9th Cir. 1986); Conover v. Dean Witter Reynolds, Inc., 794 F.2d 520 (9th Cir. 1986).


128. Id. at 1405. Rule 15c2-2 was adopted in November 1983 to address concerns related to broker-dealers' inclusion of clauses in customer contracts that compelled customers to arbitrate federal securities law claims, but that did not adequately disclose that the clauses did not appear to be binding under interpretations of securities laws then prevailing. 15 SEC. REG. & L. REP. (BNA) 2159 (1983). The obvious basis for this ruling was the Wilko doctrine.

129. Securities and Exchange Commission, Release No. 34-25034 (1987). Rule 15c2-2 embodied the SEC's determination that the inclusion of arbitration clauses in customer agreements without disclosure of their nonapplicability to claims under the federal securities laws was misleading and constituted a fraud. However, the McMahon decision made the rule inapplicable.
C. McMahon’s Effect on Claims Under the Securities Act of 1933

The McMahon ruling should receive substantial testing in a short period of time. The arbitration case load is expected to rise in the wake of the sudden stock market decline of October 19, 1987. Subsequent volatility in the market from the “crash” is expected to more than double the case load at the National Association of Securities Dealers’ (NASD) arbitration program alone. The NASD expects that more than 4,000 cases will be commenced before the end of 1987. There were 1,587 NASD arbitration cases in 1986. The 1987 case load grew 82 percent over the 1986 level. The NASD states that the 1988 pace is running at an annualized rate of 45 percent higher. The New York Stock Exchange estimates that since October the case load has increased sixty percent from levels one year earlier.

The issue concerning the arbitrability of claims brought under the Exchange Act was affirmatively resolved by the McMahon ruling. Several courts have already begun to struggle with McMahon’s effect on this issue.

Many courts are currently ruling that McMahon does not apply to claims brought forth under the Securities Act of 1933. An example of how these courts are interpreting McMahon is the case of Schultz v. Robinson-Humphrey/American Express, Inc. The Schultz court held that McMahon did not overrule Wilko. The court viewed McMahon as implicitly reaffirming the nonarbitrability of section 12 claims under the Securities Act.

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130. See, e.g., Villa Garcia v. Merrill Lynch, Pierce, Fenner & Smith, 833 F.2d 545 (5th Cir. 1987).
131. 19 SEC. REG. & L. REP. (BNA) 1657 (1987); see supra note 4. Undoubtedly, many investors will be asserting claims of churning and unsuitability concerning their investments, particularly those investors that lost substantial portfolio value. For a comprehensive analysis of the October 1987 market decline, see The October Market Break, Special Report SEC. REG. & L. REP. (BNA) 1271 (Feb. 9, 1988).
132. Id.
133. Id.
134. Id.
136. Id.
137. Id.
138. See supra notes 85-124.
139. See infra, notes 140, 147 and 151.
140. 19 SEC. REG. & L. REP. (BNA) 1329, 1330 (1988); see also Chang v. Lin, 824 F.2d 219, 222 (2d Cir. 1987) (holding that the McMahon decision did not overrule the Wilko doctrine, ruling that it continues to govern).
141. 19 SEC. REG. & L. REP. (BNA) at 1330.
142. Id.
Additionally, the *Schultz* court interpreted *McMahon* as strongly suggesting that there was a congressional ratification of *Wilko* in relation to section 12 claims. The court summarily concluded that there are distinctions between a section 12(2) claim under the Securities Act and a section 10(b) claim under the Exchange Act. These distinctions militate against an extension of the *McMahon* decision to section 12(2) claims. Thus, the *Schultz* court ruled that actions brought under the Securities Act of 1933 were not arbitrable.

The Minnesota Court of Appeals, in *Johnson v. O'Brien*, has also ruled that the *McMahon* ruling does not compel the arbitration of claims brought under section 12(2) of the Securities Act of 1933. The *Johnson* court stated:

> The respondents assert claims only under section 12(2) of the Securities Act of 1933 and do not allege any section 10(b) violations. *McMahon* addressed section 10(b) claims and the enforceability of predispute arbitration agreements within the context of arbitrability of claims under section 12(2) of the 1933 Act. Until *Wilko* is overruled, we are compelled to apply the Supreme Court's prevailing precedents with respect to predispute arbitration agreements and federal securities law.

Thus, the Minnesota Court of Appeals held that the parties' predispute arbitration agreement was not enforceable under *Wilko*.

A California district court has, however, ruled that claims brought under the Securities Act of 1933 are arbitrable. In *Weisel ex rel. Staiman v. Merrill Lynch, Pierce, Fenner & Smith*, Judge Ronald Lew ruled that the United States Supreme Court in its *McMahon* decision so seriously undermined the rationale of *Wilko* that Mr. Staiman's 1933 Act claims, like his other claims, must be sent to arbitration.

Judge Lew's reasoning was presented in two parts. First, he observed that the antiwaiver provision of both Acts are nearly identical. Thus, the court presumably held that *McMahon*'s ruling on section 29(a) of the Exchange Act can be transposed to section 14 of the Securities Act. Second, the court stated that *McMahon*'s statement, "that it can no longer be assumed that a complainant's rights

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143. *Id.*
144. *Id.*
145. *Id.*
146. *Id.*
147. 420 N.W.2d 264 (Minn. Ct. App. 1988).
148. *Id.*
149. *Id.*
150. *Id.*
153. *Id.*
could not be vindicated through arbitration," restricts Wilko application.154

Judge Lew noted that Wilko applies only where arbitration would be inadequate to protect the plaintiff's substantive rights.155 The court also stated that since the plaintiff made no showing of inadequacy of protection, then the McMahon ruling is required.156 Judge Lew, however, did indicate that an immediate appeal of the ruling would be in order since there is substantial ground for difference of opinion.157

VI. ANALYSIS

The Supreme Court's ruling in Shearson/American Express, Inc. v. McMahon compels the overruling of the Wilko doctrine. The McMahon court has ruled that section 27 of the Exchange Act does not impose any statutory duties. Thus, section 27 is procedural law and not substantive law. Therefore, the waiver of section 27 does not constitute a waiver of compliance with any provision of the Exchange Act under section 29(a).

The McMahon interpretation does not conform to the interpretation of the Wilko court. This assertion holds true even though the subject matter of the two interpretations are separate, distinct acts addressing the buying and selling of securities. The special right to recover that the Wilko court found under the section 12(2) of the Securities Act cannot contemporaneously, be seen as a substantive right in light of the McMahon court's interpretation of section 27 of the Exchange Act. The McMahon court ruled that section 27 imposes no statutory duties; hence, no substantive right exists. Section 12(2) of the Securities Act must now be read as procedural in nature and not substantive. Contrary judicial interpretations cannot stand.

The Wilko court held that the right to select a judicial forum is the kind of provision that cannot be waived because an arbitration agreement is equated to a stipulation under section 14 of the Securities Act. The McMahon court ruled that a waiver under section 29(a) of the Securities Exchange Act of 1934 does not effect a waiver of the protections of the Act. McMahon asserted that these protections were substantive protections. Thus, section 29(a) is not substantive, but procedural law. Therefore, section 29(a) does not forbid a waiver of section 27 of the Exchange Act.

154. Id.
155. See id. For an example where substantive rights were inadequately protected, see Rush v. Oppenheimer & Co., Inc., 669 F. Supp. 652 (S.D.N.Y. 1987) (court ruled that "fraudulent inducement" in signing the customer agreement makes McMahon inoperable).
156. Weisel ex rel. Staiman, 673 F. Supp. at 1011.
157. Id.
Again, the language of section 29(a) of the Exchange Act is similar to that of section 14 of the Securities Act. Since, section 14 was the cornerstone of the *Wilko* court's reasoning, the salient point of the *Wilko* decision has been frustrated. Therefore, *McMahon* dictates that section 14 of the Securities Act can now be permissibly waived.

The impact of the *McMahon* decision upon the *Wilko* doctrine comes from the *McMahon* court's affirmance of the scope and intent of the FAA, not from the statutory construction. The *McMahon* court ruled that section two of the FAA requires that security arbitration agreements "shall be valid, irrevocable, and enforceable." The Court conclusively held that the FAA firmly establishes a federal policy favoring arbitration. Consequently, the FAA, standing alone, mandates enforcement of agreements to arbitrate statutory claims. The *McMahon* court proclaimed that the basis of the *Wilko* decision was founded upon a general suspicion of arbitration and the competence of arbitration tribunals. Therefore, the *McMahon* decision mandates the enforcement of predispute arbitration clauses in brokerage firm's customer account agreements. Such agreements can only be revocable and unenforceable upon the grounds that exist at law or in equity for the revocation of any contract.

**CONCLUSION**

The scope, intent and application of the FAA now stands alone. Past judicial mistrust of arbitration tribunals do not have validity in today's courts. Arbitration should be pursued whenever it is feasible to do so. Former Chief Justice Warren E. Burger has stated that: "I cannot emphasize too strongly to those in business and industry — and especially to lawyers — that every private contract of real consequence to the parties ought to be treated as a candidate for binding private arbitration." 158

"There is some form of mass neurosis that leads many people to think courts were created to solve all the problems of mankind. We must learn from the experience of labor and management that courts are not the best places to resolve certain kinds of claims." 159 As Abraham Lincoln once stated: "Discourage litigation. Persuade your neighbors to compromise whenever you can. Point out to them how the nominal winner is often a real loser — in fees, expenses, and waste of time." 160

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159. *Id.* at 5.
160. *Id.* at 4 (quoting Abraham Lincoln).
The *Wilko* doctrine is antiquated. The decision of *Wilko v. Swan* should be overruled.161

*Robert Howe*

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161. Justice Stevens dissented to the arbitrability of 10b claims in *McMahon*. Justice Stevens stated that, because of the longevity of the *Wilko* doctrine, he thought that Congress should resolve the arbitrability issue, not the Court. Shearston/American Express, Inc. v. McMahon, 107 S. Ct. 2332, 2359 (1987) (Stevens, J., concurring in part and dissenting in part). It is an opinion worth noting. Congressional action would certainly halt much of the unwanted litigation that still surrounds the securities arbitration issue.