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With a Regulatory Shift, Questions Emerge About Investors' Access to the Courts

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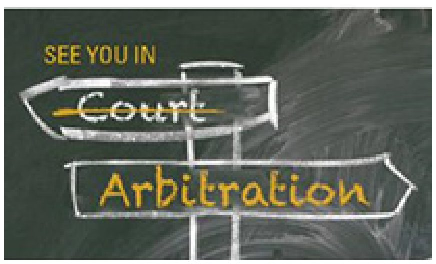
In recent years, forced arbitration clauses have swept the nation, closing the courthouse doors to countless individuals. Arbitration clauses embedded in all types of consumer and employment contracts require disputes to be resolved individually in privatized settings chosen by corporate defendants. Proponents of arbitration highlight how arbitration can reduce costs and accelerate dispute resolution, as arbitration dispenses with jury trials, certain discovery, rules of evidence, and appellate rights. On the other hand, many argue that arbitration also silences victims, enables and conceals misconduct, and often allows wrongdoers to escape public accountability. The investment community is in an uncommon position, as it has, with the help of federal regulators, generally maintained its access to public courthouses when wronged by the corporations in which it invests.



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Recent developments, however, indicate that investors may soon face a rising tide of mandatory arbitration provisions. Federal regulators, including at the U.S. Securities and Exchange Commission, have indicated a potential willingness to relax a longstanding policy prohibiting mandatory arbitration for securities claims. The investment community should take note of these developments and the possibility of rapid adoption of mandatory arbitration and class action waiver provisions across the public capital markets.

Investors Have Recovered Billions Litigating Securities Claims in Courthouses

Enforcement of the federal securities laws in public courthouses has yielded significant benefits for investors. Federal securities class actions have recovered over $100 billion for defrauded investors within the last 20 years alone, including $17 billion in financial crisis-era recoveries. Through waves of corporate misconduct, investors have banded together in class action lawsuits and secured exponentially greater recoveries for injured investors compared to regulatory actions. Investors have held wrongdoers accountable when government regulators failed to take action due to lack of resources, interest or expertise. The U.S. Supreme Court has repeatedly noted the essential role that investors play in maintaining the integrity of our nation's securities markets by bringing claims in court under the federal securities laws.

It stands to reason that the return of real money to investors, no matter the size of their investment, is only possible when investors are able to band together and enforce their rights in the courts. It is well-recognized that when the injured are prohibited from joining together, the high costs of litigation mean that far fewer suits are pursued. And when the suits that are brought are adjudicated in individual, closed-door proceedings, the public's awareness of unlawful conduct, the law's deterrence of wrongdoing, and investors' ultimate recoveries are suppressed. There are serious questions about whether, in an arbitration-only world for investors, the balance would be tilted in favor of corporate defendants. Large corporations, Wall Street banks, and national accounting firms may frequently have far superior resources than public investors. There is a risk that in an arbitration, as opposed to a public courthouse, corporate defendants could stifle the production of relevant evidence, avoid trial by juries, and have their liability adjudicated piecemeal in hand-picked arbitral tribunals.

The Potential Effects of Forced Arbitration on Securities Laws and Capital Markets

For nearly a century, public courthouses have been open to hear investors' federal securities claims seeking recovery of assets lost to fraud and other forms of corporate misconduct. Should forced arbitration provisions take hold, claims in public courthouses would likely wane, while cases brought in private arbitrations would presumably increase (although it would be hard to tell because the suits would be confidential). If the arbitration provisions come with class action waivers, "mom and pop" investors would effectively lose the critical protections that the securities laws provide. Quite simply, their individual claims would be too small to merit assuming the high costs of arbitration, particularly against well-heeled corporate interests.

Highlighting the importance of public proceedings, Commissioner Jackson emphasized that "insiders who would cheat investors know that, if they're caught, shareholders can sue—and they'll have their day in court."

Institutional investors could also lose out. Taking on the expenses and burdens of arbitration against large corporations would make economic sense for only the biggest securities frauds. Thus, in the great majority of cases, institutional investors would also lose an efficient and potent vehicle—*i.e.*, collective litigation—to recover assets lost to securities fraud. Even where an institutional investor's exposure is large enough to justify go-it-alone arbitration, the institutional investor would be forced to adjudicate its own claims with far less ammunition than in court, and in an arbitral forum selected by the corporate defendants.

Companies could also suffer under an arbitration regime. The fractured nature of arbitration—a multiplicity of individual pay-as-you-go proceedings asserting the same claims against the same parties—would likely amplify the inefficiencies, costs, and uncertainties of litigation. Securities issuers, underwriters, auditors, and their officers and directors would lose the guidance that courts provide in interpreting and applying the federal securities laws, which can be critical as new issues arise and our marketplace evolves. By effectively eliminating our nation's precedential system of justice, corporate America could soon find itself in a morass of costly arbitrations characterized by uncertainty regarding the standards governing their disclosure obligations and financial liabilities. This resulting "wild west" scenario compares poorly to the streamlined procedure of the PSLRA—where a single institutional investor leads a consolidated class action as lead plaintiff on behalf of all other like investors—and highlights how arbitration also portends significant disadvantages and difficulties for corporations.

Recent Efforts to Promote Mandatory Arbitration

The Securities and Exchange Commission has long served as a bulwark protecting investors from mandatory arbitration of securities claims. Under a policy that deemed forced arbitration and class action bans inconsistent with the federal securities laws, the SEC long refused to greenlight IPOs where companies insisted on mandatory arbitration bylaws or charter provisions. The SEC successfully persuaded companies to eliminate proposals for mandatory arbitration clauses, including in high profile instances involving The Carlyle Group, Pfizer, Google and Gannett. In fact, when a major investment advisor attempted to craft its customer agreements to bar its clients from joining class actions, the advisor retracted the provision after the SEC levied a fine.

Fast forward to today, the SEC and Treasury Department under the Trump administration have signaled a seismic policy shift with respect to forced arbitration of investors' securities fraud claims. In July, SEC Commissioner Michael S. Piwowar made a declaration in favor of mandatory arbitration for investors: "*[F]or 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.*" Following this invitation, the Treasury Department issued a report suggesting that mandatory arbitration be used as a tool to suppress shareholder litigation and class actions, and recommended that the SEC continue to investigate allowing companies to compel shareholders into arbitration.

These developments have sparked serious concern among both current and former SEC Commissioners. Current SEC Commissioner Robert Jackson, Jr., for instance, publicly noted that private securities class actions not only vindicate investors, but are a necessary and immense help to cash-strapped regulators. Highlighting the importance of public proceedings, Commissioner Jackson emphasized that "insiders who would cheat investors know that, if they're caught, shareholders can sue—and they'll have their day in court." Without federal securities class actions, he asked, how much "would Congress need to appropriate to make sure we have enough resources to do the job?" Former SEC Chairman Harvey Pitt similarly voiced his opposition, calling on the agency to put any arbitration policy shift "on the back burners" due to the SEC's "limited resources."

Faced with such criticism, in February 2018, current SEC Chairman Jay Clayton stated in Congressional testimony that he personally is "not anxious" to change the SEC's formal stance on forced arbitration. Left unclear by Clayton's statements, however, is whether he would cast a deciding vote in favor of a formal policy shift along with the SEC's two current Republican SEC Commissioners (including Commissioner Piwowar; see above). As Senator Elizabeth Warren stated during her questioning of Clayton, it stands to reason that Clayton would be "the deciding vote" on the issue. Under intense questioning by Senator Warren, Clayton had an opportunity to disavow a shift in SEC policy on forced arbitration. He did not.

The Investment Community's Options Going Forward

Given the extreme swing in regulatory sentiment, investors may wish to take stock of their options. The SEC may act quickly on a policy reversal concerning forced arbitration of securities suits, and investors may seek to work collaboratively to protect their interests. There are multiple levels on which investors could influence the public debate.

First, investors can directly advocate their position to lawmakers and regulators, especially Congress and the SEC. Such advocacy works. In 2015, institutional investors fought back against a Delaware Supreme Court ruling which appeared to endorse one-way fee-shifting bylaws designed to discourage shareholder litigation. Investors mounted a coordinated campaign that included public letters to Delaware's Governor, members of the Legislature, and shareholder advisory services, among others. In a clear victory for investors, Delaware promptly passed a law prohibiting its corporations from adopting such fee-shifting bylaws. Today, investors may wish to proactively coordinate their engagement with Congress and the SEC to keep the courthouse doors open to investors.

Second, investors can consider establishing a grassroots campaign that draws upon both shareholder advocacy groups and direct engagement with corporations that see investment dollars as a powerful weapon. Recently, over 225 prominent institutional investors with more than $26 trillion in managed assets pledged to engage directly with the world's largest carbon emitting companies. The massive campaign has already persuaded Exxon Mobil, ConocoPhillips, and Royal Dutch Shell to develop business plans that better address climate change. With such an approach, investors may also have success attempting to preserve their rights to pursue securities-fraud recoveries in the courts.

Third, investors can "vote with their assets." Last year, pressure from the institutional investor community led the top four index fund companies—S&P, Dow Jones, MSCI and FTSE Russell—to restrict from their flagship indices companies that try to employ multi-class stock structures aimed at entrenching insiders and disenfranchising public investors. The investor community could choose to send a similarly strong message by refusing to invest in companies that seek forced arbitration and class action bans, and by petitioning index providers to exclude those companies from their indexes.

The ongoing debate about arbitration of securities claims is sure to expand in the coming months, and will influence whether the investment community will continue to be protected from the sweep of forced arbitration. Public pension funds and other institutional investors should stay abreast of the latest developments in order to help ensure that federal public policy is in line with their interests and those of their fiduciaries.

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