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THE DEATH OF MANDATORY ARBITRATION OF INVESTMENT DISPUTES?

It's historic. It's comprehensive. It's ambitious. And now it's official. The *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* has been approved by Congress and signed by President Obama. Now the question is, what does this new law mean for consumers and the financial services industry?

A. Purpose of the Law

The law's stated purpose is "[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes." In furtherance of those goals, the massive law has several key provisions which aim to restore responsibility and accountability within our financial system in order to give Americans confidence in a system that offers them real protection from abusive financial practices, wall street corruption, and economic crisis.

B. Bureau of Consumer Financial Protection

One key provision of the new law (Section 1011) is the establishment of a new Bureau of Consumer Financial Protection. The Bureau of Consumer Financial Protection "shall regulate the offering and provision of consumer financial products or services under the Federal consumer financial laws." The law then grants several general powers and specific authorities to the Bureau.

C. Restricting Mandatory Arbitration Clauses

Of particular interest is the general power and authority of the Bureau to restrict mandatory pre-dispute arbitration of investment disputes. Section 1028(a) provides that the Bureau "shall conduct a study of, and shall provide a report to Congress concerning, the use of agreements providing for arbitration of any future dispute between covered persons and consumers in connection with the offering or providing of consumer financial products or services." Section 1028(b) then gives the Bureau further authority to "prohibit or impose conditions or limitations on the use of an agreement between a covered person and a consumer for a consumer financial product or service providing for arbitration of any future dispute between the parties, if the Bureau finds that such a prohibition or imposition of conditions or limitations is in the public interest and for the protection of consumers." This is truly significant for consumers and the general investing public for several reasons.

D. Arbitration in a Nutshell

Most disputes between customers and financial institutions are resolved in arbitration. Arbitration is a special dispute resolution process that serves as an alternative to a traditional lawsuit in court. Instead of arguing your case in front of a judge and jury, you argue your case before an arbitrator, or a panel of arbitrators. The arbitrators serve as impartial judges to hear all sides of the issue, study the evidence, and decide how the matter should be resolved. The arbitrator's decision is final, and as a general rule it cannot be appealed.

Brokerage firms typically require clients to sign a new account form before opening an investment account. These forms almost always have an arbitration clause hidden somewhere within the account paperwork, which has important ramifications. Many investors do not notice the arbitration clause, but it effectively prevents a defrauded investor from bringing a court action. And if an investor does notice the clause before signing the paperwork, the brokerage firm will typically refuse to negotiate the terms of the agreement. Investors are left with no choice but to waive their rights, as arbitration clauses are presented on a take-it-or-leave-it basis. Consequently, most cases against brokerage firms are arbitrated before a FINRA[1] panel.

E. The Upside and Downside of Arbitration

It has been argued that the arbitration process tends to be more efficient, more cost-effective, and at least as fair as a traditional court proceeding. Arbitration can typically be completed in less than 12 months, in comparison to a traditional trial in court which may take 4 to 6 years. Arbitration can usually be completed at less than half the cost of a traditional trial in court. And customers win in arbitration about 50% of the time, which is consistent with traditional court proceedings.

However, arbitration has it drawbacks. There are steep filing fees that a consumer must pay to initiate a case, which discourages many consumers from moving forward. And although the panel of arbitrators is supposed to be "neutral," the panels are composed of corporate executives, attorneys, and industry insiders, and these affiliations can influence their decisions. In fact, FINRA is a securities-industry-funded organization. The result is that arbitration awards to consumers tend to be substantially lower than court awards. So although the consumer may win the battle by getting a favorable decision in his case (i.e., the arbitrators find the broker liable), the consumer may lose the war when he receives a minimal or reduced financial award compared to what he could have received in court.

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[1] FINRA is the "Financial Industry Regulatory Authority". FINRA is the largest independent regulator for all securities firms doing business in the United States. FINRA oversees nearly 4,700 brokerage firms, 167,000 branch offices, and approximately 635,000 registered securities representatives.

F. Give Consumers a Choice and Let the Best System Win

Proponents of arbitration emphasize the efficiency of the arbitration process because it's usually faster and cheaper than going to court. But *efficiency* may not be the best benchmark in determining where to proceed with a claim. Perhaps *effectiveness* should be given due consideration? And what about consumer *choice*? And what about the entire point of the new law, which is to enhance consumer protection? If arbitration is not providing an appropriate level of consumer protection in comparison to judicial proceedings, then clearly the Bureau should exercise its authority and prohibit or limit the use of pre-dispute mandatory arbitration clauses in brokerage account paperwork.

It seems that the best solution is to give consumers a choice of whether they want to proceed in arbitration or in court. Depending on the situation, one forum may be more appealing than the other, and consumers and their attorneys should have the freedom to make strategic and tactical decisions about the forum in which they wish to resolve the dispute. If arbitration really is the better choice, then consumers and their legal counsel will choose arbitration. Indeed, it is likely that arbitration will appeal to many consumers and attorneys due to its reputation for being a cost-effective and relatively quick way to get a case resolved.

The bottom line is that arbitration should be available as an *alternative* forum. It should not be the *only* forum. The new financial reform law has the potential to help level the playing field between large financial institutions and average investors. If investors are given the freedom to select the battle field, they will have a better shot at winning the war. Let's hope that the new financial reform law brings about this much needed and long overdue change. It would be a step in the right direction for consumer protection.

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