FACILITATING ECONOMIC RECOVERY AND SUSTAINABLE GROWTH THROUGH REFORM OF THE SECURITIES CLASS-ACTION SYSTEM: EXPLORING ARBITRATION AS AN ALTERNATIVE TO LITIGATION

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INTRODUCTION

In the aftermath of the global economic collapse of 2008, policymakers from around the world have been considering regulations designed to reduce the risk of future economic turmoil. Their focus has been on powers and procedures designed to reduce systemic risk and to help ensure financial stability in the world markets.[1] Although policymakers should explore prophylactic measures and use counterfactual reasoning, they should not confine their analysis to preventing the next crisis. Regulating against the risk of unpredictable disaster—a so-called "black swan"[2]—is imprecise and, if done improperly, can hinder economic growth. Along these lines, policymakers must be cautious to avoid a regulatory overreaction to the current economic problems.[3] In an effort to promote long-term economic prosperity, policymakers should avoid the temptation to overregulate in the near term.

Policymakers also must alleviate unnecessary burdens to economic growth, both in the United States and abroad. But a monetary response, such as a stimulus spending package, provides only short-term economic relief and could cause a host of problems not discussed in this Article. To promote long-term and sustainable growth, policymakers must consider regulatory measures designed to facilitate capital formation and encourage investment, while providing appropriate safeguards against fraud to investors. Of course, the legal and regulatory systems may pose the greatest impediment to economic growth.[4]

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1. *See* GROUP OF TWENTY, DECLARATION: SUMMIT ON FINANCIAL MARKETS AND THE WORLD ECONOMY 1 (2008) (stating that recent efforts to support the global economy and stabilize financial markets must be followed with reforms to prevent another crisis).

2. *See generally* NASSIM NICHOLAS TALEB, THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE (2007).

3. *See* Lawrence Leibowitz, Group Executive Vice President & Head of U.S. Mkt. & Global Tech., NYSE Euronext, Inc., Address at the NYSE Euronext Securities Industry and Financial Markets Association Market Structure Conference, Key Issues Facing the Financial Markets: Time to Re-Engage (May 20, 2009), *available at* http://www.nyse.com/about/nyseviewpoint/1243591675565.html ("We have to be really careful about regulatory and legislative overreaction, at the same time realizing that the Wild West doesn't serve the public good either.").

4. For example, a recent study by the Committee on Capital Markets Regulation noted that "[e]xcessive regulatory costs and risk of litigation are the most likely causes of" the decline in U.S. market share of the global IPO market. LUIGI ZINGALES ET AL., INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 38 (2006).

The United States has its own unique hindrance to economic growth: private securities class-action litigation. Along with Canada and Australia, the United States is one of three G-20 nations to permit securities class actions.[5] Although originally envisioned as a means to provide relief to aggrieved investors, securities class-action litigation has become an inefficient and grossly incomplete means of redress for investors, a costly encumbrance to businesses, and a threat to capital formation in the United States.

To be sure, access to a properly administered class-action framework provides aggrieved plaintiffs with a valuable legal recourse. Despite the drawbacks, class actions—as opposed to individual actions—are necessary to avoid the collective action problem that exists when investors accrue claims against publicly held corporations. In the absence of a class action, an individual shareholder might have little incentive to litigate an alleged securities law violation because he would be forced to bear all the costs of litigation while receiving only a fraction of the potential benefits paid to all shareholders. Class-action litigation avoids the collective action problem by allowing a class of shareholders, following the efforts of lead plaintiffs and plaintiffs' attorneys, to share the costs and benefits of a unified action proportionately.

The problem with the existing class-action framework in the United States is the overuse and abuse of the litigation system. The magnitude of securities class-action litigation in the United States is astonishing. Nearly half of all class-action lawsuits in 2004 involved allegations of federal securities law violations.[6] In 2008, 210 securities class-action lawsuits were filed.[7] The number of securities class-action lawsuits appears to have dou-

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5. John C. Coffee, Jr., *Foreign Issuers Fear Global Class Actions*, NAT'L L.J., June 14, 2007, at 12 (stating that foreign issuers now fear entering the U.S. market because "listing on a U.S. exchange exposes the foreign issuer to potentially bankrupting securities liabilities if its stock price were to decline sharply" and that "the securities class action is not available as a practical matter elsewhere in the world, with the possible exceptions of Canada and Australia").

6. U.S. CHAMBER INST. FOR LEGAL REFORM, SECURITIES CLASS ACTION LITIGATION: THE PROBLEM, ITS IMPACT, AND THE PATH TO REFORM 3 (2008) [hereinafter SECURITIES CLASS ACTION LITIGATION].

7. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS 2008: A YEAR IN REVIEW 2 (2009) [hereinafter SECURITIES CLASS ACTION FILINGS 2008].

bled in each recent year,[8] and the total number of securities class-action settlements in 2008 was three times that of 1998.[9]

The threat of securities class actions is more pronounced in periods of increased volatility in stock prices. A two-year trough in securities class-action filings from June 2005 through June 2007—a period characterized by a strong and stable stock market—was followed by a period of increased class-action filings through June 2008—during which stock market volatility doubled.[10]

The current system of securities class-action litigation is an inefficient means to redress the harm to investors. Prominent studies have concluded that securities class-action litigation fails to compensate adequately those harmed by fraud.[11] The median ratio of settlement amount to total alleged investor loss has ranged between two and three percent.[12] Securities class-action lawsuits are essentially wealth transfers among shareholders and often are circular in nature. Existing shareholders bear the burden of compensating aggrieved shareholders, some of whom also may be existing shareholders.

Although individual class members receive relatively little of the ultimate recovery that is spread across a class, the plaintiffs' attorneys receive customarily twenty to twenty-five percent of the total recovery.[13] During the past ten years, plaintiffs' lawyers, along with other middlemen, have obtained nearly $17 billion in fees from securities class actions.[14] The diffused investors in the

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8. *See id.* at i.

9. ELLEN M. RYAN & LAURA E. SIMMONS, SECURITIES CLASS ACTION SETTLEMENTS: 2008 REVIEW AND ANALYSIS 1 (2009) [hereinafter 2008 CLASS ACTION SETTLEMENTS]; LAURA E. SIMMONS & ELLEN M. RYAN, SECURITIES CLASS ACTION SETTLEMENTS: 2007 REVIEW AND ANALYSIS 1 (2008) [hereinafter 2007 CLASS ACTION SETTLEMENTS].

10. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS: 2008 MID-YEAR ASSESSMENT 3 (2008) [hereinafter 2008 MID-YEAR ASSESSMENT].

11. Joseph A. Grundfest, Statement at the Meeting of the Advisory Committee on the Auditing Profession 3–4 (Feb. 4, 2008), *available at* http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Grundfest02042008.pdf.

12. SECURITIES CLASS ACTION LITIGATION, *supra* note 6, at ii.

13. Fischel v. Equitable Life Assur. Soc., 307 F.3d 997, 1006 (9th Cir. 2002) (describing a "25 percent 'benchmark'" in percentage-of-the-fund cases that can be altered as required by the needs of the case). Of those persons who were class members of various class actions, fifty-three percent reported in a survey that they did not receive anything of meaningful value. *See* U.S. CHAMBER OF COMMERCE, INSTITUTE FOR LEGAL REFORM, POLLING ON THE CLASS ACTION SYSTEM: NATIONAL RESULTS 1 (2003) [hereinafter POLLING ON THE CLASS ACTION SYSTEM].

14. SECURITIES CLASS ACTION LITIGATION, *supra* note 6, at ii.

class lack the ability to bargain over attorney fees and courts rarely reduce the fees proposed by the plaintiffs' attorneys.[15]

In class-action litigation, the interests of the plaintiffs' attorneys and class members may not be aligned in some instances. The plaintiffs' attorneys bear the full costs of pursuing the litigation but receive only a portion of the ultimate award. Consequently, the decisions of the plaintiffs' attorneys may be driven by concern over litigation costs and personal gain rather than by an interest in obtaining the best result for class members. Indeed, the recent scandals involving plaintiffs' attorneys paying large sums to repeat plaintiffs illustrate how class-action litigation can be abused at the expense of harmed investors.[16]

Companies and their shareholders incur enormous costs to defend against securities class-action lawsuits. In one recent study, approximately forty-one percent of the companies listed on the major stock exchanges had been named as defendants in at least one federal securities class action.[17] The total monetary value of securities class-action settlements in 2008 was $3.09 billion.[18] The average settlement value from 2002 to 2008 was $45.6 million, which represents approximately a 175% increase from the average value of $16.6 million from 1996 to 2001.[19]

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15. *See* POLLING ON THE CLASS ACTION SYSTEM, *supra* note 13, at 1 (stating that in a 2003 survey sponsored by the U.S. Chamber of Commerce, sixty-seven percent of persons surveyed believe that lawyers benefit most from the current class-action lawsuit system). *But see* In re Baan Co. Sec. Litig., 288 F. Supp. 2d 14, 22 (D.D.C. 2003) (rejecting a request by plaintiffs' attorneys for thirty-two percent of the settlement fund and instead awarding twenty-eight percent of the fund).

16. *See, e.g.*, Julie Creswell, *U.S. Indictment for Big Law Firm in Class Actions*, N.Y. TIMES, May 19, 2006, at A1; *see also* Carrie Sheffield, *House GOP wants probe into Milberg Weiss scandal*, WASH. TIMES, May 2, 2008, http://www.washingtontimes.com/weblogs/fishwrap/2008/may/02/house-gop-wants-probe-into-milberg-weiss-scandal (quoting in full a letter dated May 2, 2008 from Rep. John Boehner and Rep. Lamar Smith to Rep. John Conyers, House Judiciary Committee Chairman, stating in part: "According to federal investigators, Milberg Weiss officials masterminded a $250 million illegal kickback scheme involving their clients, and then lied in court about their actions. . . .The . . . scandal has implications for every American, particularly at a time when our economy is struggling and the triple threat of excessive regulation, taxation, and litigation is pushing jobs overseas").

17. *See* COMMISSION ON THE REGULATION OF THE U.S. CAPITAL MARKETS IN THE 21ST CENTURY, U.S. CHAMBER OF COMMERCE, REPORT AND RECOMMENDATIONS 30 (2007) [hereinafter CHAMBER COMMISSION REPORT].

18. 2008 CLASS ACTION SETTLEMENTS, *supra* note 9, at 1.

19. STEPHANIE PLANCICH & SVETLANA STARYHK, RECENT TRENDS IN SECURITIES CLASS ACTION LITIGATION: 2009 MID-YEAR UPDATE 22 (2009) [hereinafter 2009 MID-YEAR UPDATE].

Private securities litigation has become a real concern, particularly for new businesses that do not have the resources to handle a large lawsuit. A major lawsuit could sound the death knell for new companies that already bear a disproportionate amount of the total business tort costs in the United States. Although small companies account for nineteen percent of business revenue in the United States, they bear sixty-nine percent ($98 billion) of the business tort costs.[20] To cope with the cost of securities litigation, companies must raise the prices of their goods and services.[21] Doing so, in turn, logically harms the competitiveness of U.S. businesses in a global marketplace that is dominated by low-cost goods and services in the nations where providers do not face such threats.

Securities class actions impose a competitive disadvantage on U.S. capital markets relative to markets in other countries. Indeed, foreign companies are reluctant to list in U.S. markets due to concerns with the American litigation system.[22] According to the Committee on Capital Markets Regulation—an independent, bipartisan body composed of twenty-two corporate and financial leaders from business, finance, law, accounting, and academia—since the late 1990s the percentage of the world's Initial Public Offerings (IPOs) conducted in the United States has dropped from forty-eight percent to six percent in 2005.[23] Of the world's twenty-five largest IPOs in 2005, only one of them took place in the United States.[24] That trend continued in 2006, when a report dated November 30 observed that, in the year to date, nine of the ten largest IPOs had occurred in markets outside of the United States.[25] Dollar figures are also staggering: Between 2000 and 2005, the percentage of

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20. U.S. CHAMBER INST. FOR LEGAL REFORM, TORT LIABILITY COSTS FOR SMALL BUSINESS 7 (2007).

21. A 2003 survey found that seventy-four percent of Americans surveyed think that the class-action system drives up prices. POLLING ON THE CLASS ACTION SYSTEM, *supra* note 13, at 1.

22. MCKINSEY & CO., SUSTAINING NEW YORK'S AND THE US' GLOBAL FINANCIAL SERVICES LEADERSHIP 101 (2007) [hereinafter MCKINSEY REPORT] ("[N]ot only are foreign companies staying away from U.S. capital markets for fear that the potential costs of litigation will more than outweigh any incremental benefits of cheaper capital, but a number of interviewees also suggested that the legal environment is detrimental to America's spirit of entrepreneurialism and innovation.").

23. ZINGALES ET AL., *supra* note 4, at 2.

24. *Id.*

25. *Id.*

dollars raised in global IPOs in the United States decreased by a factor of ten, dropping from fifty percent to five percent.[26]

Where is the IPO activity going? The Committee report states that over the same time, London's share of the global IPO market nearly quintupled from five percent to almost twenty-five percent.[27] United States exchanges attracted only about one-third of the share of the global IPO volume in 2006 that they had in 2001[28] and only three of the twenty largest IPOs of 2008 were listed on U.S. stock exchanges.[29] In 2009, the United States regained the global lead in amount of funds raised in IPOs, boasting a robust twenty-seven percent share of global capital raised.[30] But this number may be of little comfort when one considers that the share is mostly attributed to the $19.6 billion Visa IPO—the largest IPO in U.S. capital market history.[31] Looking beyond this single outlier, it is apparent that capital formation has moved overseas in droves.

An unwieldy class-action regime impacts not only the market for public offerings, but also the market for private offerings. The success of the venture capital industry relies, in large part, on how readily a start-up or other privately held company can be taken public. Absent a desire to access the public equity markets in the United States, the amount of private equity activity in the United States also suffers.[32]

In contrast to federal litigation, securities arbitration appears to provide a more efficient and cost-effective mechanism to resolve disputes with integrity while minimizing the burdens on our judicial system. Arbitration ensures that all relevant facts

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26. *Id.*

27. *Id.* at 3; *see also* MCKINSEY REPORT, *supra* note 22, at ii ("[T]he legal environments in other nations, including Great Britain, far more effectively discourage frivolous litigation . . . .").

28. MCKINSEY REPORT, *supra* note 22, at 43.

29. *See id.* at 16.

30. ERNST & YOUNG, SHIFTING LANDSCAPE—ARE YOU READY?: GLOBAL IPO TRENDS REPORT 18 (2009).

31. *Id.*

32. Brief for the Nasdaq Stock Mkt., Inc. and NYSE Euronext as Amici Curiae Supporting Respondents at 6, Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008) (No. 06-43) (explaining that "the contribution of strong capital markets to overall economic growth is well documented"). The damage to capital markets caused by securities class actions does not stop at U.S. shores. One of the more recent developments in the universe of securities class-action litigation is the so-called "F-cubed" class action, which pits a foreign-listed, foreign corporation against a foreign investor in U.S. federal court.

are presented to the panel without the evidentiary hurdles of federal court. In addition, the use of arbitrators knowledgeable about the securities industry may reduce the uncertainty of resolving securities claims in jury trials.

The arbitration system used by the Financial Industry Regulatory Authority (FINRA), the self-regulatory organization that oversees certain securities firms, could be a model for the resolution of class actions, but an arbitration forum for securities class-action claims would have to account for the unique circumstances of those claims. Unfortunately, the federal court system provides the only permissible avenue at present to resolve class-action claims under the federal securities laws. Although arbitration is an avenue to adjudicate scores of different types of claims, the self-regulatory organizations expressly prohibit arbitration of securities class-action claims.

This Article analyzes the impediments to arbitration of securities class-action claims. It describes the concerns with the current system of shareholder class actions and discusses the benefits and criticisms associated with arbitration. Finally, this Article recommends that policymakers explore options to use arbitration for securities class-action claims. One option is to permit arbitration of a limited number of securities class-action lawsuits following a federal court's denial of a defendant's motion to dismiss. Another option is to allow new public companies the opportunity to choose between arbitration and litigation at the time of the initial public offering of securities. By providing new public issuers the choice of forum at the time of the IPO and then providing sufficient ongoing notice to the marketplace of the chosen forum, investors can decide for themselves the significance of the arbitration forum prior to the decision to purchase the stock. This scenario may provide relief to smaller companies from the class-action lawsuits that have plagued them, while protecting investors and providing the opportunity to further study and evaluate the use of class-action arbitration in a real-world context.

I. THE ECONOMIC COSTS AND BENEFITS OF SECURITIES CLASS-ACTION LAWSUITS

A. *The Burdens on the Federal Judiciary*

Securities class-action lawsuits dominate the federal docket. In 2004, securities class actions accounted for forty-eight percent of all federal class actions in the United States.[33] Due to their legal and factual complexity, securities class actions require more judicial time and attention than other types of lawsuits. They require unusual procedural attention (due to the selection of a lead plaintiff and lead counsel), often require multiple attempts at repleading and multiple motions to dismiss, and generally take longer to resolve as a result of the voluminous document requests and depositions following the denial of a motion to dismiss.[34]

Despite opinions by the Supreme Court that aim to curtail frivolous lawsuits, the number of securities class-action lawsuits continues to grow. There was a fifty-eight percent increase in new lawsuits from 2006 to 2007.[35] In 2008, securities class action filings reached a six-year high with 259 filings.[36] Filings have kept pace in 2009, with 127 cases filed in the first half of the year.[37] Filings of securities class-action lawsuits may have some correlation with stock market volatility. According to a report by NERA Economic Consulting, market volatility is positively correlated with the number of securities class-action filings, and "if market volatility is higher during a quarter, controlling for market returns, filings are likely to be higher in the same quarter."[38]

B. The Costs to Individual Companies

In addition to the costs to the judicial system, the costs of securities class actions to individual companies are enormous. Since 1996, at least 3,013 securities class actions have been filed.[39] Approximately 2,465 public companies—forty-one percent of the approximately 6,000 companies currently listed on the major stock exchanges—have been named as defendants in at least one

33. SECURITIES CLASS ACTION LITIGATION, *supra* note 6, at 3.
34. *See* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1540 (2006).
35. SECURITIES CLASS ACTION LITIGATION, *supra* note 6, at i.
36. 2009 MID-YEAR UPDATE, *supra* note 19, at 1.
37. *Id.*
38. STEPHANIE PLANCICH ET AL., 2008 TRENDS: SUBPRIME AND AUCTION-RATE CASES CONTINUE TO DRIVE FILINGS, AND LARGE SETTLEMENTS KEEP AVERAGES HIGH 1 (2008) [hereinafter NERA 2008 MID-YEAR UPDATE].
39. Stanford Securities Class Action Clearinghouse, http://securities.stanford.edu (last visited Jan. 16, 2010).

federal securities class action.[40] In 2009, 4.6% of all S&P 500 listed companies were defendants in a *newly* filed class action.[41]

Another alarming threat to the competitiveness of United States markets is the growing and disproportionate number of securities class-action lawsuits against foreign companies. In 2008, class actions filed in federal court against foreign companies increased by seven percent.[42] The increase in lawsuits has been so sharp that foreign issuers currently face a disproportionately higher percentage of lawsuits than domestic issuers. As of June 30, 2009, foreign companies account for fifteen percent of all securities class-action defendants, but comprise only thirteen percent of exchange-listed companies.[43]

In addition to the increasing number of securities class-action lawsuits, the claims against companies have increased dramatically in size. There are two measures that illustrate this point: the disclosure dollar loss and the maximum dollar loss. With the disclosure dollar loss, the size of a claim is measured by reference to the decline in market capitalization from the day before the class period ends to the day after the corrective disclosure. With the maximum dollar loss, the size of a claim is measured by reference to the decline in market capitalization from the maximum price point during the class period to the day after the corrective disclosure. The total disclosure dollar loss in 2008 was $227 billion, which represents a forty-eight percent increase from 2007 and a seventy-five percent increase relative to the eleven-year average from 1997 to 2007.[44] The maximum dollar loss in 2008 was $856 billion, which represents a twenty-seven percent increase from 2007.[45]

The larger the claim, the greater the leverage plaintiffs' attorneys have to obtain a settlement. This leverage exists even

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40. CHAMBER COMMISSION REPORT, *supra* note 17, at 30.

41. CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS 2009: A YEAR IN REVIEW 12 (2010).

42. 2009 MID-YEAR UPDATE, *supra* note 19, at 9 (showing a rise from 27 to 29 class actions).

43. *See id.* at 10.

44. *See* 2008 MID-YEAR ASSESSMENT, *supra* note 10, at 9; *see also* SECURITIES CLASS ACTION FILINGS 2008, *supra* note 7, at 14–15.

45. *See* SECURITIES CLASS ACTION FILINGS 2008, *supra* note 7, at 14. It is important to recognize that investors should have redress for valid claims under the law. Redress should be achieved, however, in the most cost-effective and efficient means possible, which may not be achieved under the current private securities litigation framework.

for claims lacking merit. This leverage is significant because nearly every securities class-action lawsuit settles before trial.[46] If a defendant loses its motion to dismiss, it is faced with a Hobson's choice: settle the case for millions (or sometimes billions) of dollars *or* incur large legal bills and divert company resources to fight the claims at trial while facing the risk that a jury will render a potentially catastrophic verdict against the company. For new and small issuers, a large judgment can be especially devastating.[47] Since the enactment of the Private Securities Litigation Reform Act, approximately forty-four percent of securities class-action lawsuits have been either dismissed or had a summary judgment entered for the defendant, and fifty-six percent have settled with all defendants, leaving only a small percentage of cases to reach a verdict at trial.[48]

The concerns with securities class-action litigation transcend party lines. Former Attorney General Dick Thornburgh, who served in the Reagan and George H. W. Bush administrations, observed: "Outcomes [of securities class-action lawsuits] are often less a matter of justice than of negotiation, as many defendants decide it is better to settle than to incur the enormous costs, inconvenience and risks associated with what may become virtually endless litigation."[49] Robert E. Litan, a former Clinton Administration official, similarly stated: "[S]ome defendants can feel financially pressured to settle even if they have done nothing wrong, believing it not to be worth betting their companies on a subsequent mistaken jury verdict that can be difficult to overturn on an appeal."[50] The Supreme Court acknowledged these concerns in the landmark *Stoneridge* case.[51] The Court stated that "extensive discovery and the potential

46. *See* 2009 MID-YEAR UPDATE, *supra* note 19, at 15; Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 528–34 (1991).

47. *See* ANJAN V. THAKOR, U.S. CHAMBER INST. FOR LEGAL REFORM, THE UNINTENDED CONSEQUENCES OF SECURITIES LITIGATION 9–10 (2005).

48. 2009 MID-YEAR UPDATE, *supra* note 19, at 15.

49. Dick Thornburgh, Op-Ed., *Class action gamesmanship*, WASH. TIMES, July 15, 2007, at A14.

50. ROBERT E. LITAN, U.S. CHAMBER INST. FOR LEGAL REFORM, THROUGH THEIR EYES: HOW FOREIGN INVESTORS VIEW AND REACT TO THE U.S. LEGAL SYSTEM 13 (2007).

51. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008).

for uncertainty and disruption in a lawsuit allow plaintiffs with weak claims to extort settlements from innocent companies."[52]

The settlement amounts of private securities class-action lawsuits have increased dramatically over the past decade. The average settlement amount from 2002 to 2007 was $70.1 million, which represents approximately a 250% increase from the average amount of $28.2 million from 1998 to 2001.[53] These figures are driven, in part, by several large settlements in the past few years. According to a study by the Chamber of Commerce, "Nine of the ten largest securities class action settlements of all time occurred in the past three years, and nine of those top ten exceeded 1 billion dollars."[54] Nevertheless, excluding settlements over one billion dollars, the average settlement amount from 2002 to 2007 was $24.4 million, which represents approximately a 200% increase from the average amount of $11.5 million from 1996 to 2001.[55] The total amount of all securities class-action settlements in 2008 was $3.09 billion.[56] Although the average settlement in 2008 decreased approximately fifty percent from 2007,[57] the average settlement amount is expected to increase in the coming years as the claims currently pending are resolved.

C. *The Costs to the United States Capital Markets and Economy*

Securities class-action lawsuits pose a strong impediment to economic growth in the United States. The threat of private securities class-action lawsuits is among the primary disincentives to listing on U.S. exchanges. The Financial Services Roundtable, a financial services industry trade group, opined both that "[e]xcessive litigation and the threat of litigation are the most significant impediments to the competitiveness of U.S. businesses"[58] and that "the growth in class action lawsuits, especially securities class-action cases, imposes substantial uncer-

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52. *Id.* at 163.

53. 2007 CLASS ACTION SETTLEMENTS, *supra* note 9, at 1–2.

54. SECURITIES CLASS ACTION LITIGATION, *supra* note 6, at 8.

55. STEPHANIE PLANCICH ET AL., 2007 YEAR END UPDATE: RECENT TRENDS IN SHAREHOLDER CLASS ACTIONS: FILINGS RETURN TO 2005 LEVELS AS SUBPRIME CASES TAKE OFF; AVERAGE SETTLEMENTS HIT NEW HIGH 12 (2008) [hereinafter 2007 YEAR END UPDATE].

56. 2008 CLASS ACTION SETTLEMENTS, *supra* note 9, at 1.

57. *See id.* at 2.

58. RICHARD M. KOVACEVICH ET AL., FIN. SERVS. ROUNDTABLE, THE BLUEPRINT FOR U.S. FINANCIAL COMPETITIVENESS 63 (2007).

tainties and costs and presents a major competitive challenge to U.S. financial services firms in comparison to foreign firms that are not subject to a similar risk."[59]

One of the most comprehensive studies of the effects of private securities litigation on the competitiveness of the United States markets was commissioned by Senator Charles E. Schumer and Mayor of New York Michael R. Bloomberg and conducted by McKinsey & Company. McKinsey's 2007 report concluded that "the prevalence of meritless securities lawsuits and settlements in the U.S. has driven up the apparent and actual cost of doing business—and driven away potential investors."[60] The report found:

> [T]he high legal cost of doing business in the U.S. financial services industry is of real concern to corporate executives. When asked which aspect of the legal system most significantly affected the business environment, senior executives surveyed indicated that propensity toward legal action was the predominant problem.[61]

Indeed, eighty-five percent of CEOs surveyed indicated that they preferred London to New York due to the litigation risk associated with U.S. markets.[62]

Another recent survey conducted by the Financial Services Forum—which polled 334 senior executives of companies based in the United States, United Kingdom, Germany, France, China, Japan, and India—confirms these conclusions. According to the survey,

> [o]ne out of three companies in the survey that considered going public in the United States rated litigation as an 'extremely important' factor in their decision, and nine out of 10 companies who de-listed from a U.S. exchange in the last four years said the litigation environment played some role in that decision.[63]

The survey also stated that "[o]ne out of four U.S.-listed public companies cited litigation reform as the most significant

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59. *Id.*
60. MCKINSEY REPORT, *supra* note 22, at ii.
61. *Id.* at 75.
62. *Id.*
63. THE FIN. SERVS. FORUM, 2007 GLOBAL CAPITAL MARKETS SURVEY 8 (2007) [hereinafter 2007 GLOBAL CAPITAL MARKETS SURVEY].

step the U.S. can take to improve the attractiveness of U.S. capital markets."[64]

These results are confirmed by figures showing that a growing number of companies are looking overseas to raise capital. As previously noted, in 2006, U.S. exchanges attracted only about one-third of the share of the global IPO volume as compared to 2001.[65] Indeed, "[i]n 2006, more capital was raised through initial public offerings . . . on the Hong Kong Stock Exchange than on the New York Stock Exchange and NASDAQ combined."[66]

D. Analysis of the Purported Benefits of Securities Class-Action Lawsuits

Proponents of securities class-action lawsuits have argued that securities litigation deters wrongdoing and compensates injured shareholders. Neither of these purported reasons has much support in theory or practice. The Committee on Capital Markets Regulation has concluded that "[t]he modern securities class-action lawsuit creates a heavy burden for public companies; without a substantial social benefit, this burden cannot be justified. . . . [T]he public value of the securities class action litigation is questionable."[67]

The Committee made three key findings to support its conclusions. First, "the potential deterrent function of private securities litigation is debatable because virtually all the costs fall on the corporation and its insurer, which means they are ultimately borne by the shareholders."[68] Second, "the notion that securities class actions do a good job of compensating injured parties is belied by data suggesting that the average securities class action settles for between two percent and three percent of the investors' economic losses."[69] Third,

> even if there is a net recovery, contemporary securities class action litigation is still suffering from a problem of circularity. The recovery is largely paid by diversified shareholders to diversified shareholders and thus represents a pocket-shifting wealth transfer that compensates no one in any

64. *Id*.
65. MCKINSEY REPORT, *supra* note 22, at 43.
66. 2007 GLOBAL CAPITAL MARKETS SURVEY, *supra* note 63, at 2.
67. ZINGALES ET AL., *supra* note 4, at 78.
68. *Id.*
69. *Id.* at 79.

> meaningful sense and that incurs substantial wasteful transaction costs in the process.[70]

Investors who held shares at the time of the fraud pay the settlement to investors who purchased or sold during the period of the fraud.[71]

The notion of any benefit to injured shareholders from securities class-action lawsuits is further belied by the fact that most investors have a diversified portfolio,[72] and thus may suffer little or no net harm from securities fraud. Diversified investors are essentially protected against fraud in an individual security by having a portfolio of other investments with low correlation to one another.[73] When considering all costs associated with securities litigation, such as the negative effects on raising capital, distraction of management, and attorney fees—which customarily exceed twenty percent of the recovery for plaintiffs attorneys,[74] and perhaps a comparable amount for defense attorneys[75]—both society and investors in the aggregate are net losers under the current private securities litigation regime.

Professor Joseph Grundfest, a former SEC commissioner, summarized the problems with securities class-action litigation:

> The conclusion is clear. The class action securities fraud litigation system is broken. It fails efficiently to deter fraud and fails rationally to compensate those harmed by fraud. Its greatest proponents seem to be the class action counsel and

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70. *Id*.

71. *See id.*

72. *See* K.J. Martijn Cremers & Jianping Mei, *Turning Over Turnover* (Yale ICF Working Paper No. 03-26, 2005), *available at* http://ssrn.com/abstract=452720 (finding that up to approximately three quarters of trading is motivated by rationales other than stock picking); Utpal Bhattacharya & Neil Galpin, The Global Rise of the Value-Weighted Portfolio 3 (Mar. 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=849627 (finding that trading in the value-weighted portfolio has increased over time and accounts for sixty-eight percent of the trading volume in the 2000s).

73. *See* Brian M. Rom & Kathleen W. Ferguson, "*Portfolio Theory is Alive and Well": A Response*, J. INVESTING, Fall 1994, at 24, 26.

74. *See* ZINGALES ET AL., *supra* note 4, at 79.

75. *See id.*; *see also* Tom Baker & Sean J. Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' & Officers' Liability Insurance Market*, 74 U. CHI. L. REV. 487, 495 n.29 (2007) (discussing defense costs and how they may amount to twenty-five percent or more of a settlement amount).

others who profit as a consequence of the irrationally large damage exposures generated by the current regime.[76]

II. ARBITRATION OF SECURITIES LAW CLAIMS

A. The Development of the Law

Arbitration has become a widespread practice in resolving disputes between broker-dealers and their customers. Virtually every customer agreement contains an explicit clause requiring that disputes be heard in arbitration. Under the Federal Arbitration Act (FAA),[77] agreements to arbitrate future disputes are generally enforceable.[78] Although the FAA has existed for over three quarters of a century, arbitration of claims under the Securities Act of 1933[79] and the Securities Exchange Act of 1934[80] is a relatively recent concept.

In 1953, the Supreme Court in *Wilko v. Swan* held that the FAA does not apply to the provisions of the Securities Act of 1933 designed to protect investors.[81] Although the FAA specifically permits parties to elect contractually to arbitrate their claims,[82] Section 14 of the Securities Act of 1933 expressly voids any attempt to waive the securities laws.[83] The Court held that Section 14 would therefore invalidate any clause requiring parties to arbitrate claims under the Securities Act of 1933.[84] The Court expressed concern with arbitration as a forum to adjudicate provisions of the Securities Act, stating that "their effectiveness in application is

76. Joseph A. Grundfest, Professor of Law and Bus., Stanford Law Sch., Statement at the Meeting of the Advisory Committee on the Auditing Profession 4 (Feb. 4, 2008), *available at* http://www.treas.gov/offices/domestic-finance/acap/submissions/02042008/Grundfest02042008.pdf.

77. 9 U.S.C. §§ 1–16 (2006).

78. *See* 9 U.S.C. § 2 ("A written provision in . . . a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.").

79. 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–bbbb (2006)).

80. 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–nn (2006)).

81. 346 U.S. 427, 438 (1953).

82. *See* 9 U.S.C. § 3.

83. 15 U.S.C. § 77n ("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.").

84. *Wilko*, 346 U.S. at 437–38.

lessened in arbitration as compared to judicial proceedings."[85] The Court conceded the difficulty in reaching that conclusion:

> Two policies, not easily reconcilable, are involved in this case. Congress has afforded participants in transactions subject to its legislative power an opportunity generally to secure prompt, economical and adequate solution of controversies through arbitration if the parties are willing to accept less certainty of legally correct adjustment. On the other hand, it has enacted the Securities Act to protect the rights of investors and has forbidden a waiver of any of those rights. Recognizing the advantages that prior agreements for arbitration may provide for the solution of commercial controversies, we decide 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.[86]

Several federal courts subsequently extended *Wilko* to the Securities Exchange Act of 1934.[87] In 1987, however, the Supreme Court in *Shearson/American Express, Inc. v. McMahon* held that *Wilko* did not apply to claims under the Securities Exchange Act of 1934.[88] Two years after *McMahon*, the Supreme Court in *Rodriguez de Quijas v. Shearson/American Express, Inc.* overruled *Wilko* and held that pre-disputed arbitration agreements would be upheld, even concerning matters arising under the Securities Act of 1933.[89] The Court stated: "Our conclusion is reinforced by our assessment that resort to the arbitration process does not inherently undermine any of the substantive rights afforded to petitioners under the Securities Act."[90]

In the midst of the *Rodriguez de Quijas* and *McMahon* litigation, the Securities and Exchange Commission, under the direction of Chairman David Ruder, directed all the self-regulatory organizations (SROs) "to consider adopting procedures that would give investors access to the courts in appropriate cases, including class actions."[91] In response, the Securities Industry

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85. *Id.* at 435.

86. *Id.* at 438 (footnote omitted).

87. *See* Constantine N. Katsoris, *Securities Arbitration After* McMahon, 16 FORDHAM URB. L.J. 361, 366 n.38 (1988) (collecting cases).

88. 482 U.S. 220, 238 (1987).

89. 490 U.S. 477, 484 (1989).

90. *Id.* at 485–86.

91. Proposed Rule Change by NASD Relating to Improvements in the NASD Code of Arbitration Procedure, 57 Fed. Reg. 30,519, 30,520 (July 1, 1992).

Conference on Arbitration (SICA) met and unanimously adopted a rule to exclude the arbitration of securities class-action lawsuits.[92] The National Association of Securities Dealers, Inc. (NASD) submitted that proposed rule to the SEC, and the Commission approved the proposed rule on October 28, 1992. In approving the rule, the Commission explained:

> The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the NASD. Specifically, the Commission finds that the proposed rule change is consistent with the requirements of section 15A(b)(6) of the Act. Section 15A(b)(6) requires, in part, that the rules of the NASD be designed "to protect investors and the public interest * * *." Over the years of the evolution of class action litigation, the courts have developed the procedures and expertise for managing class actions. Duplication of the often complex procedural safeguards necessary for these hybrid lawsuits is unnecessary. The Commission believes that investor access to the courts should be preserved for class actions and that the rule change approved herein provides a sound procedure for the management of class actions arising out of securities industry disputes between NASD members and their customers.[93]

The Commission did not base its approval of the proposed rule on concerns over the integrity of the arbitration process. Indeed, NASD represented—and the SEC agreed—that "arbitration provides adequate due process procedures and that arbitrators are well-trained and possess the expertise to manage complex cases."[94] Instead, the Commission recognized that the judicial system already had developed procedures to manage class-action lawsuits, and thus "[e]ntertaining such claims through arbitration at the NASD would be difficult, duplicative and wasteful."[95] Other SROs sought and received approval for the same rule.[96]

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92. Order Approving Proposed Rule Change Relating to the Exclusion of Class Actions From Arbitration Proceedings, 57 Fed. Reg. 52,659, 52,660 (Oct. 28, 1992).

93. *Id.* at 52,661.

94. *Id.*

95. *Id*.

96. *See* Order Granting Approval to Proposed Rule Change Relating to the Exchange's Arbitration Rules, 61 Fed. Reg. 2849, 2849 (Jan. 22, 1996); Filing of Proposed Rule Change by NASD Relating to Exclusion of Class Action Claims from Arbitration, 59 Fed. Reg. 4299, 4299 (Jan. 24, 1994) (clarifying that exclusion applies to actions brought by employees, as well as by customers); Order Approving Proposed Rule Change by American Stock Exchange, Inc. Relating to Arbitration, 58 Fed. Reg. 48,680,

B. The Integrity of Securities Arbitration

In the 1980s and leading up to the SROs' decision to prohibit arbitration of class-action claims, securities arbitration received harsh criticism for being biased towards the securities industry. For example, Justice Blackmun in his dissenting opinion in *McMahon* wrote: "[T]here remains the danger that, *at worst*, compelling an investor to arbitrate securities claims puts him in a forum controlled by the securities industry. This result directly contradicts the goal of both securities Acts to free the investor from the control of the market professional."[97]

Concerns with arbitration have subsided in large part since *McMahon*. In 2002, the Securities and Exchange Commission sponsored a study by Professor Michael Perino regarding the operation of arbitrator disclosure requirements in securities arbitration.[98] From his review of data from more than 30,000 SRO arbitrations, Professor Perino found that the evidence suggested that SRO arbitrations are fair—favoring neither industry member nor investor—and that any undisclosed conflicts of interest do not present any significant problems.[99] Professor Perino found persuasive the General Accounting Office's (GAO) 1992 report, *Securities Arbitration: How Investors Fare*, which examined results in arbitration over an eighteen-month period between 1989 and 1990.[100] That report concluded that there was "no evidence of pro-industry bias" in arbitrations sponsored by the NASD, NYSE, and other SROs when compared to arbitrations

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48,680–81 (Sept. 10, 1993); Order Granting Approval to Proposed Rule Change Relating to Amendments to Rule 12, Arbitration, of the Rules of the PSE, 58 Fed. Reg. 42,588, 42,588 (July 30, 1993); Order Approving Proposed Rule Change Relating to the Exclusion of Class Actions from Arbitration Proceedings, 57 Fed. Reg. 52,659, 52,659 (Oct. 28, 1992); Proposed Rule Change by National Association of Securities Dealers, Inc., Relating to Improvements in the NASD Code of Arbitration Procedure, 57 Fed. Reg. 30,519, 30,519–20 (July 1, 1992).

97. Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 260 (1987) (Blackmun, J., concurring in part and dissenting in part).

98. MICHAEL A. PERINO, REPORT TO THE SECURITIES AND EXCHANGE COMMISSION REGARDING ARBITRATOR CONFLICT DISCLOSURE REQUIREMENTS IN NASD AND NYSE ARBITRATIONS 2 (2002).

99. *Id.* at 3–5, 48.

100. U.S. GEN. ACCOUNTING OFFICE, SECURITIES ARBITRATION: HOW INVESTORS FARE 23 (1992) [hereinafter GAO REPORT]. Oddly, this GAO study occurred contemporaneously with the SEC's decision to approve rules to bar securities class-action arbitration. *See supra* notes 91–92 and accompanying text.

conducted by the American Arbitration Association (AAA),[101] an independent organization involved in arbitrations in a variety of areas. The GAO found that panels in SRO arbitrations ruled in favor of investors in about fifty-nine percent of arbitrations versus sixty percent in AAA-sponsored arbitrations, and prevailing investors received average awards of about sixty-one percent of the damages, as opposed to awards averaging fifty-seven percent of amounts claimed in AAA proceedings.[102]

More recently, in October 2007, the Securities Industry and Financial Markets Association (SIFMA) issued a *White Paper on Arbitration in the Securities Industry*.[103] The *White Paper* concluded that Securities Arbitration is "fair" to investors based, in part, on statistical evidence collected by the GAO and others showing that arbitrations are conducted fairly and not biased in favor of the industry.[104] A survey of securities arbitration participants found that approximately ninety-three percent of those surveyed—more than fifty percent of whom were investors—believed their case had been handled fairly and without bias.[105] In addition, from a review of all 2005 and 2006 arbitration decisions, the *White Paper* stated that "the presence of an 'industry' arbitrator has no material impact on customer wins."[106] According to the *White Paper*, "[s]ecurities arbitration is in fact fair because arbitrators understand the law and ensure it is properly followed and applied in each case."[107]

Not all of the recent studies, however, have reached the same results. Under funding by FINRA, SICA conducted a survey in 2007 of participants in the securities arbitration process. In its February 2008 report, SICA indicated that seventy-five percent of investors surveyed who compared the arbitration process to civil litigation indicated that arbitration was "very unfair" or "somewhat unfair."[108] The survey also indicated that, of those

101. GAO REPORT, *supra* note 100, at 60.

102. *Id.* at 38–39.

103. SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION, WHITE PAPER ON ARBITRATION IN THE SECURITIES INDUSTRY (2007) [hereinafter WHITE PAPER].

104. *Id.* at 34–37.

105. GARY TIDWELL ET AL., PARTY EVALUATIONS OF ARBITRATORS: AN ANALYSIS OF DATA COLLECTED BY NASD REGULATION ARBITRATIONS 3–5 (1999).

106. WHITE PAPER, *supra* note 103, at 4, 67.

107. *Id.* at 4.

108. JILL I. GROSS & BARBARA BLACK, PERCEPTIONS OF FAIRNESS OF SECURITIES ARBITRATION: AN EMPIRICAL STUDY 47 (2008).

participating, approximately half of the investors in the survey believed that their arbitration panel was biased,[109] approximately fifty-two percent would not recommend arbitration to others,[110] approximately seventy-one percent were dissatisfied with the outcome of their arbitration,[111] and forty-nine percent stated that the arbitration process was too expensive.[112]

Of course, each of the studies investigating the "fairness" of arbitration suffers from an inherent flaw on its face. To the extent that "fairness" is an appropriate standard, the concept is ambiguous and difficult to measure—that is, entirely subjective. An investor may feel arbitration was unfair simply because he received a low monetary award. Measuring satisfaction in the outcome is thus entirely subjective and ripe for misinterpretation. Accordingly, SIFMA criticized the SICA survey for its flawed statistical methodology, claiming it focused solely on subjective perceptions over a narrow time frame.[113]

C. Key Benefits of Arbitration

Despite survey results suggesting that participants are displeased with the cost, arbitration does not burden litigants with the costly and time-consuming procedures present in federal litigation. In federal court, parties generally "may obtain discovery regarding any nonprivileged matter that is relevant to any party's claim or defense."[114] Parties in federal litigation also may depose ten witnesses without leave of court and more with leave, which is usually freely given in securities class actions.[115]

By contrast, discovery in arbitration is narrowly tailored, less costly, and faster than in federal court litigation.[116] Discovery gen-

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109. *Id.* at 53.

110. *Id.* at 43.

111. *Id.* at 38.

112. *Id.* at 41.

113. *See* SEC. INDUS. & FIN. MKTS. ASS'N, THE THINKING PERSON'S GUIDE TO INTERPRETING THE LATEST SURVEY ON SUBJECTIVE PERCEPTIONS OF FAIRNESS OF SECURITIES ARBITRATION 1–3 (2008).

114. FED. R. CIV. P. 26(b)(1).

115. FED. R. CIV. P. 30(a)(2).

116. *See* WHITE PAPER, *supra* note 103, at 28–29; *see also Arbitration Fairness Act of 2007: Hearing on S. 1782 Before the Subcomm. on the Constitution of the S. Comm. on the Judiciary*, 110th Cong. 211 (2007) (testimony of SIFMA) ("In contrast [to litigation], arbitration allows for a simple statement of claim, an answer, focused and limited discovery, and then a full merits hearing. While pre-hearing motions are permitted, they are disfa-

erally is limited to the exchange of documents and information of presumptively discoverable material specified on discovery lists.[117] Although parties may request additional information, those additional requests are limited to "identification of individuals, entities, and time periods related to the dispute."[118] Interrogatories and depositions are permitted only in limited circumstances.[119] The result is perhaps a less costly and more efficient discovery process for the parties. Indeed, a former president of the American Bar Association said that a "ratio of 3 or 4 to one, litigation versus arbitration, is a fairly realistic estimate [of the cost savings from arbitration] and a reasonable expectation is that the cost of an arbitration will not be in excess of half the cost of litigating."[120] Although he was not speaking about arbitration of class actions, cost savings likely would be significantly larger for securities class actions, which often last several years.

Motion practice is limited in arbitration.[121] In federal court, a defendant may file a motion to dismiss,[122] and both plaintiffs and defendants may file a motion for summary judgment.[123] Although motions are permitted in arbitration,[124] their use was curtailed significantly by FINRA on September 26, 2007, when it limited the number of motions permitted.[125] Therefore, it is

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vored and more limited in arbitration versus court. The costs to get to a hearing are a fraction of what they are in traditional litigation."); PETER B. RUTLEDGE, U.S. CHAMBER INST. FOR LEGAL REFORM, ARBITRATION – A GOOD DEAL FOR CONSUMERS: A RESPONSE TO PUBLIC CITIZEN 27 (2008) ("A system of targeted discovery, in contrast to the fishing expeditions that typify civil litigation, helps to ensure that a case is resolved more quickly. . . . [S]tudies . . . consistently conclude that arbitration delivers results more quickly than litigation. Moreover, a system of targeted discovery obviously lowers the costs of resolving the dispute." (citing Lewis L. Maltby, *Private Justice: Employment Arbitration and Civil Rights*, 30 COLUM. HUM. RTS. L. REV. 29, 55 (1998))).

117. FINRA, CODE OF ARBITRATION PROCEDURE § 12506 (2009).

118. *Id.* § 12507(a)(1).

119. *Id.* § 12510.

120. WHITE PAPER, *supra* note 103, at 29 (quoting William G. Paul, Remarks at First Annual Energy Litigation Program: Arbitration v. Litigation in Energy Cases 3 (Nov. 7–8, 2002)).

121. *See id.* at 26–28; *see also* J.S. "Chris" Christie, Jr., *Preparing for and Prevailing at an Arbitration Hearing*, 32 AM. J. TRIAL ADVOC. 265, 266 (2008).

122. *See* FED. R. CIV. P. 12(b)(6).

123. *See* FED. R. CIV. P. 56.

124. *See* FINRA, *supra* note 117, § 12503.

125. Press Release, FINRA, FINRA Board Approves Rule To Limit Motions To Dismiss in Arbitrations (Sept. 26, 2007), *available at* http://www.finra.org/Newsroom/NewsReleases/2007/P037048.

extremely unlikely that a claim will be dismissed on pleading grounds in arbitration.[126]

Unlike litigation in federal district court, arbitration does not impose any rigorous evidentiary hurdles to examining witnesses and presenting information. Arbitrators generally permit parties to submit information into the record without requiring strict adherence to evidentiary foundations. Witnesses can be questioned not only by the lawyers but also (and often) by the arbitrators. These relaxed evidentiary standards mean more information gets before the arbitration panel for consideration in reaching an outcome and the process is driven more by the parties, not the lawyers.[127]

Another possible benefit associated with arbitration—although continually debated—is the use of skilled arbitrators with experience in resolving such disputes. For example, FINRA carefully selects arbitrators from a broad cross-section of applicants, diverse in culture, profession, and background. Potential arbitrators must have at least "five years of full-time, paid business or professional experience."[128] Potential arbitrators also must be recommended in writing by two persons who can personally attest to their integrity and skills.[129] Arbitrators must provide regular disclosures regarding employment history, education, training, conflicts, and associations with industry members.[130]

Before serving on an arbitral panel, a potential arbitrator must complete FINRA's comprehensive arbitrator training program, which consists of an eight-hour online training course and a

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126. *See* WHITE PAPER, *supra* note 103, at 28 (finding that "it is highly unlikely that a claim will be dismissed solely on pleading grounds in arbitration"). Claims in court, however, are commonly dismissed on pleading grounds. *See id.* at 27 (stating that between 2005 and 2007, motions to dismiss accounted for 39.1% of the dispositions in securities class action suits).

127. *See* Thomas A Dubbs & Michael W. Stocker, *Securities Law: In debt crisis, an arbitration alternative*, NAT'L L.J., Mar. 16, 2009, http://www.labaton.com/en/about/published/upload/National-Law-Journal-March-16-2009-TAD-MWS-purchased-eprint-copy.pdf (stating that relaxed evidentiary rules "create a strong incentive to give a full and open hearing to all facts relevant to a case subject to arbitration"); *see also* WHITE PAPER, *supra* note 103, at 31–33.

128. *See* FINRA, Frequently Asked Questions About Becoming a FINRA Arbitrator, http://www.finra.org/ArbitrationMediation/Neutrals/BecomeAnArbitrator/FAQ/ (last visited Feb. 22, 2010).

129. *Id.*

130. *See* Order Approving Proposed Rule Change by the NASD Relating to Proposal to Conduct Background Verification and Charge Application Fee for NASD Neutral Roster Applicants, 68 Fed. Reg. 56,661, 56,661–62 (Sept. 25, 2003).

four-hour classroom course that provides "practical guidance for resolving common issues that arise during arbitration."[131] An arbitrator seeking to serve as chairperson of an arbitration panel must complete an additional nine-hour course.[132]

Under existing FINRA arbitration, claims may be heard depending on their size by either a sole "public" arbitrator or a panel of three arbitrators, two of whom must be public and one of whom is "non-public" (also known as an "industry" arbitrator). A non-public arbitrator is a person who within the past five years was associated with a broker or dealer, registered under the Commodity Exchange Act, a member of an exchange or a futures association, or associated with a person or firm registered under the Commodity Exchange Act.[133] In addition, arbitrators may be defined as non-public if they have spent a substantial part of their careers, including legal careers, engaging in, or working on behalf of, the above listed businesses, or if they are employed by a financial institution that effects transactions in securities or monitors compliance with securities laws.[134] By contrast, a public arbitrator is a person who is not engaged in any of the activities described above, has not been engaged in those activities for over twenty years, and is not affiliated in certain respect to persons or entities in the securities industry.[135] Therefore, panels with three arbitrators have one arbitrator that has relevant experience in the securities business.

Some argue that the non-public (industry) arbitrators assist arbitration panels in reaching the right decision by providing much-needed expertise.[136] By understanding the industry, non-public arbitrators may be better able to distinguish violations from non-violations. Others argue that non-public arbitrators

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131. FINRA, Basic Arbitrator Training, http://www.finra.org/ArbitrationMediation/Neutrals/Education/ArbitratorTraining/MandatoryTraining/index.htm (last visited Feb. 22, 2010).

132. FINRA, Advanced Arbitrator Training, http://www.finra.org/ArbitrationMediation/Neutrals/Education/ArbitratorTraining/VoluntaryTraining/index.htm (last visited Feb. 22, 2010).

133. FINRA, *supra* note 117, § 12100(p).

134. *See id.*

135. *Id.* § 12100(u).

136. *See, e.g.*, WHITE PAPER, *supra* note 103, at 35–37.

may be biased in favor of defendants.[137] In response to that concern, FINRA launched a two-year pilot program beginning in fall 2008 that allows some investors in arbitration to choose a panel composed of three public arbitrators instead of the normal panel of two public arbitrators and one non-public arbitrator.[138] Six major brokerage firms have volunteered to participate in the pilot program.[139] The investor making the arbitration claim may elect to participate in the pilot program, but the firms are not permitted to elect whether or not to do so.[140]

FINRA indicated that it will evaluate the pilot program according to the percentage of investors who opt into the pilot and the percentage of investors who choose an all-public panel after opting in, among other criteria.[141] "FINRA will compare the results of pilot and non-pilot investor cases, including the percentage of cases that settle before award (and how quickly they settle)."[142] FINRA also has indicated that it will study the length of hearings and the use of expert witnesses in pilot and non-pilot cases.[143]

The results to date of the pilot program show that investors are choosing to have a non-public (industry) arbitrator on their panel about half the time even when they have had the opportunity to choose an all public arbitrator panel.[144] FINRA announced on October 5, 2009:

> To date, in the 225 pilot cases where ranking lists have been returned, investors have ranked one or more non-public arbitrators half the time and struck all eight non-public arbitrators in the other half. Thus, investors are choosing to have a non-public arbitrator in 50 percent of the pilot cases.[145]

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137. *See, e.g.*, Gretchen Morgenson, *Is this Game Already Over?: Critics Say Arbitration Panels Often Have Hidden Conflicts*, N.Y. TIMES, June 18, 2006, § 3 (Sunday Business), at 1.

138. *See* Press Release, FINRA, FINRA to Launch Pilot Program to Evaluate All-Public Arbitration Panels (July 24, 2008), *available at* http://www.finra.org/Newsroom/NewsReleases/2008/P038958.

139. *See id.*

140. *See id.*

141. *See id.*

142. *Id.*

143. *See id.*

144. Press Release, FINRA, FINRA to Expand Program Evaluating All-Public Arbitration Panels (Oct. 5, 2009), *available at* http://www.finra.org/Newsroom/NewsReleases/2009/P120101.

145. *Id.*

As a result, FINRA announced that it would expand the pilot program from eleven to fourteen broker dealers, and the number of eligible cases will increase from 276 to 411.[146] The results of this pilot program and other studies may be informative in shaping a system for class-wide arbitration of securities claims.

D. Criticisms of Arbitration

Unlike claims brought in federal court, arbitration claims are not subject to strict pleading standards. In federal court, the Federal Rules of Civil Procedure require a plaintiff claiming fraud to allege "with particularity" the specific facts upon which his claim is based.[147] In addition, the Private Securities Litigation Reform Act of 1995 (PSLRA) has heightened further the pleadings standards. It requires that a plaintiff bringing an action under the Securities Exchange Act of 1934 include in his complaint "each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed."[148] Under the PSLRA, a plaintiff also must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[149] The Supreme Court further explained in 2007 that "an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent."[150]

By contrast, pleading standards in arbitration are relaxed in order to encourage claimants to pursue their disputes. A claimant simply may file a Statement of Claim, "specifying the relevant facts and remedies requested."[151] Motion practice is limited in arbitration, and as a result dismissals are rare at that stage.[152] The relaxed pleading in arbitration allows panels to award damages to customers even where the same claims may not have survived a

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146. *Id.*
147. FED. R. CIV. P. 9(b).
148. 15 U.S.C. § 78u-4(b)(1) (2006).
149. 15 U.S.C. § 78u-4(b)(2).
150. Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007).
151. FINRA, *supra* note 117, § 12302(a)(1).
152. *See* WHITE PAPER, *supra* note 103, at 26–28.

motion to dismiss in federal court.[153] The statistics are consistent with such a supposition: Twenty percent of all arbitration claims ultimately are decided by arbitrators, while less than two percent of civil claims filed in court are decided by a judge or jury.[154]

Other criticisms of arbitration concern the autonomy of arbitrators and the lack of review of their decisions. Arbitrators have greater flexibility than federal judges to fashion an outcome based on the amorphous principles of fairness and equity.[155] Because arbitration decisions are rarely published, arbitrators are free to fashion equitable remedies without fear of public reprisal. This raises concerns of a "shadow" common law system for securities law claims in arbitration.[156] Moreover, appellate challenges are constrained by statute. Under the Federal Arbitration Act, a court "must" confirm an award "unless [it] is vacated, modified, or corrected as prescribed in sections 10 and 11."[157] Section 10 lists grounds for vacating an award, including where the award was procured by "corruption," "fraud," or "undue means," and where the arbitrators were "guilty of misconduct," or "exceeded their powers."[158] The grounds for modifying or correcting an award under Section 11 include "evident material miscalculation," "evident material mistake," and "imperfect[ions] in [a] matter of form not affecting the merits."[159]

Congress has taken note of this trend towards arbitration. Concerns over arbitration in general (not limited specifically to securities arbitration) prompted some members of Congress to introduce legislation providing additional safeguards to individuals in the arbitration process. On July 12, 2007, Representative Hank Johnson of Georgia and eight other members of the United States House of Representatives introduced House bill

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153. *See id.* at 26 ("Whereas motion practice is standard in courts, SRO arbitration generally discourages dispositive motions.").

154. *See id.* at 3.

155. *See* SEC. INDUS. CONFERENCE ON ARBITRATION, THE ARBITRATOR'S MANUAL, at i (2007) ("Equity is justice in that it goes beyond the written law. And it is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas the judge looks only to the law, and the reason why arbitrators were appointed was that equity might prevail." (citation and internal quotation marks omitted)).

156. The concept of a shadow common law system in arbitration that parallels the Article III judicial system is a fascinating topic, but it is beyond the scope of this Article.

157. 9 U.S.C. § 9 (2006).

158. 9 U.S.C. § 10(a).

159. 9 U.S.C. § 11.

3010, entitled, "Arbitration Fairness Act of 2007."[160] The "findings" set forth in the bill state that "[m]ost consumers . . . have little or no meaningful option whether to submit their claims to arbitration" and that "[m]any corporations add to their arbitration clauses unfair provisions that deliberately tilt the systems against individuals, including provisions that strip individuals of substantive statutory rights, ban class actions, and force people to arbitrate their claims hundreds of miles from their homes."[161] The findings also reiterate some longstanding criticisms concerning arbitration, such as the lack of judicial review of decisions and the lack of published decisions.[162] Based on these and other findings, the proposed legislation prohibits a pre-dispute arbitration agreement for arbitration of a "consumer" dispute or "a dispute arising under any statute intended . . . to regulate contracts or transactions between parties of unequal bargaining power."[163] The language arguably seems to cover securities class actions. Hearings were held on the bill, and it was referred out of the House Judiciary Committee's Subcommittee on Commercial and Administrative Law.[164] As yet, the bill has not been brought to a vote.

III. ARBITRATION OF SECURITIES CLASS-ACTION CLAIMS AFTER THE MOTION-TO-DISMISS STAGE

As discussed, the primary criticisms of securities class-action litigation are the enormous costs associated with discovery, the distraction to management of prolonged litigation, and the large settlements extracted due to uncertainty with the jury system. As a practical matter, however, these concerns do not manifest themselves until after the district court has ruled against a defendant's motion to dismiss. Prior to the motion to dismiss, discovery is stayed under the PLSRA's automatic stay, which states: "In any private action . . . all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss."[165]

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160. H.R. 3010, 110th Cong. (2007).

161. *Id.* § 2(3), (7).

162. *See id.* § 2(5)–(6).

163. *Id.* § 4(4).

164. *See* H.R. 3010: Arbitration Fairness Act of 2007, http://www.govtrack.us/congress/bill.xpd?bill=h110-3010 (last visited Feb. 22, 2010).

165. 15 U.S.C. §§ 77z-1(b)(1), 78u-4(b)(3)(B) (2006). In creating the automatic stay, Congress found that approximately eighty percent of the costs of litigating securities

Theoretically, a system could be developed to allow issuers to amend their state charters to allow arbitration of securities class-action claims. However, certain limitations should be imposed to avoid abuse and to help ensure integrity in the process. First, arbitration of a securities class-action claim could be permitted only after a district court's denial of a motion to dismiss. Such a system would enable the federal district courts to retain jurisdiction over the difficult legal questions and to provide guidance to the arbitration panel concerning the governing law. This system would avoid the criticism that arbitration panels are ill-suited to handle motions practice. Moreover, because the majority of litigation costs to the parties in securities litigation are not incurred until after the motion to dismiss, the use of arbitration following the denial of a motion to dismiss would alleviate some of the litigation costs.

Second, using their existing authority,[166] arbitrators could determine in their discretion whether to allow for depositions and interrogatories, and, if so, to what extent. Arbitrators should determine when certain cases warrant these forms of discovery. Unlike federal court litigation, which provides for depositions and interrogatories as a matter of right,[167] arbitration allows for the panel to tailor discovery to the individual facts of the cases.

Third, to serve as a disincentive to parties bringing frivolous claims, the prevailing party (as determined by the arbitration panel) could be entitled to have its attorney fees paid by the losing party. The amount of fees could be determined by the arbitration panel based on various factors such as attorney and paralegal hours spent on the case and the complexity of the case. They could in no event exceed a maximum percentage of the recovery unless a special need exists. This fee structure would encourage lawyers to represent clients in arbitration, yet it would avoid a windfall to lawyers at the expense of their clients.

Fourth, the ultimate rulings by the arbitration panel, including the amount of damages and attorney fees awarded, could be reviewed by a federal district court applying an abuse-of-discretion standard. If the court finds that the damages awarded by the arbitration panel are not based on a sound

class actions were associated with discovery. *See* S. REP. NO. 104–98 (1995), *reprinted in* 1995 U.S.C.C.A.N. 683, 688, 693.

166. *See* FINRA, *supra* note 117, § 12510.

167. *See* FED. R. CIV. P. 26; FED. R. CIV. P. 30.

economic analysis, the court could modify the amount as it deems appropriate.

Although such a system might address many of the concerns associated with securities class-action litigation, it admittedly would not be a panacea. Indeed, damage awards may be higher, the number of claims may increase, and uncertainty may grow. Of course, a full and complete study would be necessary before launching such a program. Conceptually, however, by allowing arbitration as a way to handle claims, the system would recognize the freedom of contract and allow an alternative avenue to adjudicate claims that could be priced into the value of an issuer's securities. Policymakers should explore whether such a system appropriately balances the interests of the various stakeholders while adequately protecting investors.

IV. ALLOWING NEW ISSUERS TO ELECT ARBITRATION AT THE TIME OF THE INITIAL PUBLIC OFFERING

Another alternative use of arbitration could permit companies to elect arbitration as the forum for dispute resolution at the time the companies file their registration statements to go public. The investors receiving shares in the primary market would be on notice that class claims will be arbitrated. Disclosure mechanisms would need to be put into place to inform potential investors in the secondary markets prior to investing. For instance, the consolidated tape could be marked with an indicator and an additional disclosure requirement could be added to a company's 10-K and 10-Q to alert investors that claims related to that security will be arbitrated. Provided that existence of an arbitration clause for securities class-action claims is disclosed adequately to the entire market, investors can make a conscious and informed decision about whether to invest.

By offering arbitration as an option for new issuers, this approach may help to energize the IPO market and encourage capital formation. Although businesses often can rely on private placements and venture capital to raise capital, the public markets provide a better, more efficient, and lower cost avenue to raise capital over time to grow the business.[168] It is essential

168. Of course, the class-action regime not only influences the market for public offerings, but also influences the market for private offerings. The success of the venture

that the United States government encourage companies—both domestic and foreign—to avail themselves of U.S. public markets. The injection of new capital, particularly foreign capital, into U.S. markets and the availability of new enterprises for investment are critical to creating growth in the economy. Allowing new public companies to avoid the inefficient, costly, and risky litigation system when defending class claims may be a simple, low-cost catalyst for attracting new capital. Indeed, as mentioned above, research indicates that excessive regulatory costs and the risk of litigation inhibit the IPO market in the United States and contribute to its decline relative to those markets abroad.[169]

This approach may provide much-needed relief to smaller companies from the class-action lawsuits that have curbed their growth and threatened their existence, while providing the opportunity to further study and evaluate the use of class-action arbitration in an actual setting. It likely would provide objective criteria—stock prices—to evaluate investor perceptions of litigation versus arbitration. If investors are concerned with arbitration, that concern should be reflected in a depressed stock price. In other words, there might be a discount in the share price if investors are concerned with the inability to litigate in federal court. If, on the other hand, investors deem the arbitration clause to be beneficial to the company and their investment, then the stock should trade at a premium.

By permitting companies at the time of their initial public offering to choose their forum of dispute resolution, this approach effectively provides investors with the choice of forum. Investors unwilling to relinquish the right to litigate in federal court simply can choose not to invest in the security. On the other hand, investors may find it attractive to invest in a company not subjected to the burdens and uncertainties of class-action litigation. Over time, the marketplace should help to dictate a company's decision, while providing a meaningful choice to investors.[170]

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capital industry relies in large part on how readily a start-up or other privately held company can be taken public.

169. *See* CHAMBER COMMISSION REPORT, *supra* note 17, at 38.

170. The interests of investors should not be secondary to the interests of a company, of course. Shareholders (in other words, investors holding equity in a company) *are* the company, and any system of adjudication must protect their interests over those of their lawyers and provide appropriate safeguards to protect the integrity of the process.

CONCLUSION

As policymakers grapple with the recent economic turmoil, they undoubtedly will consider measures to reinvigorate and strengthen global capital markets worldwide. A system of securities arbitration as an alternative to securities class-action litigation in federal courts may facilitate capital formation, make U.S. markets more competitive on the global stage, and ultimately spur economic growth by reducing the costs of capital. There are indications that a significant deterrent to capital formation in the United States is the risk of an expensive class-action lawsuit likely to result in a corporation paying millions of dollars to settle claims with questionable merit. Indeed, the likelihood that the corporation will settle for many millions of dollars is increased by the expense and unpredictability of the system of securities class actions. As the large number of securities class actions that settle once the plaintiffs overcome the motion to dismiss demonstrate, corporations often prefer to settle class-action lawsuits than to incur significant litigation costs and risk losing at trial.

Aggrieved investors need a method to receive redress for legitimate securities claims, but reforming the current securities class-action system is long overdue. When considering methods to reinvigorate and strengthen capital markets, policy makers should explore whether arbitration provides an efficient mechanism to address many of the concerns identified with securities class-action litigation. Concerns about arbitration appear to have been rebutted by research indicating that the arbitration process is unbiased and that participants are generally satisfied with the process. Nevertheless, policymakers should continue to study the arbitration system to determine whether it presents an appropriate means to resolve class-action claims. In the process, they should consider alternatives such as allowing litigants to elect arbitration following the denial of a motion to dismiss or allowing a new issue to elect arbitration in its initial public offering documents. These approaches may strike the appropriate balance of protecting the interests of investors while providing for a more efficient and less costly resolution of claims.