Commentary: Obama's Plan to End Securities Arbitration

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Obama's new Consumer Financial Protection Agency (CFPA) would have the authority to restrict or ban mandatory arbitration clauses in contracts for financial services. The financial press has not focused on the ramifications of this proposal, which would have a significant impact on the securities industry. Unless an arbitration clause is mandatory in contracts for investment services, many fewer disputes within the securities industry are likely to be resolved through arbitration.

For the time being, it's not certain that the proposed CFPA's authority actually will reach into the securities industry. At least so far, the SEC has been able to convince members of Congress that, newly motivated and properly funded, it can sufficiently protect investors, notwithstanding past failures. However, I find it hard to believe that mandatory arbitration clauses will be prohibited for consumers of all other financial services, yet be allowed for consumers of services provided by broker-dealers.

It is also true that the proposed ban on mandatory arbitration would not cover intra-industry disputes, which means that employment litigation for employees of financial services firms still may be handled almost exclusively through arbitration. However, intra-industry disputes are the tip of the iceberg in securities arbitration. I doubt there be much enthusiasm to maintain the sort of resources necessary at FINRA to keep the arbitration machinery running, if the only arbitration cases it processed were intra-industry disputes.

The primary virtue of arbitration is economic – it is less expensive. As every litigator can tell you, economics is the senior partner in every lawsuit. There is no case where litigators have a free hand to do everything possible to ensure victory. There is always a budget, which means that lawyers must limit their efforts to those issues that are expected to be most fruitful. So, any process that offers a less expensive method of resolving disputes has seductive appeal.

Moreover, the costs of arbitration are borne entirely by litigants. Disputes resolved within the judicial system dip into the taxpayer's purse because the costs of maintaining the courts, and the salaries of judges and judicial staff, are paid for by the government. In its relentless search for ways to cut government spending without alienating favored constituencies, Congress has encouraged arbitration as the favored means to resolve civil disputes, and the Supreme Court has upheld the constitutionality of this method of dispute resolution.

Arbitration is less expensive because it limits discovery, the process by which a party must disclose to its adversary evidence related to the dispute. There is an old maxim: "Surprise is the enemy of justice." The purpose of discovery is to eliminate the "surprise witness" that made Perry Mason such a lion of the Hollywood bar.

A just result is much more likely if both parties have access to all of the evidence available in a case. If one party is holding back a surprise, the trial will be decided by ambush. In disputes between a customer and a broker-dealer, it is generally the broker-dealer that possesses most of the evidence, providing its lawyers the most opportunities to produce a surprise at an arbitration hearing. Trial by ambush rarely leads to a just result.

Over time, the process of discovery in the judicial system has evolved to the point where, by the time discovery is complete, actual trials only occur about two percent of the time in civil disputes. The reason for this is that when both parties to a dispute have all the evidence in hand that will be used to try a case, it is usually possible to predict the outcome with a fair degree of accuracy.

The process of discovery has been developing in arbitration, as well, reducing its cost advantage. However, it is still severely limited, as compared to cases tried in the courts. So, in contrast to the judicial dispute resolution process, more than 25% of arbitration cases are resolved in an arbitration hearing before a panel of arbitrators, rather than by a settlement between the parties. Trial by ambush remains commonplace in arbitration, casting continuing doubt on the justice served up by this method of dispute resolution.

On the other hand, economics is also the enemy of justice. The tools of discovery in the hands of a well-funded litigant can be used to wear an opponent down. In this and many other ways, our judicial system favors the well-heeled, since justice can only be obtained by those who can pay for its costs. The poor who seek justice in civil disputes generally must rely on the charity of members of the Bar and the poorly-funded legal services available through government agencies. It goes without saying that the discovery that can be obtained through the resources available to the poor are no match for an adversary who can pay the going rate for legal services.

To discourage abusive discovery tactics, federal judges participate actively in the discovery process. Active judicial participation in discovery makes the process fair, but raises the costs for taxpayers. In my view, these are tax dollars well spent. We are all better off if there is a just resolution of civil disputes through a fair and impartial process. However, it is costly enough that active judicial participation is not common in the State courts, and the level of judicial attention to the discovery process varies from State to State.

For these reasons, it is not enough simply to eliminate securities arbitration without also giving consideration to what would replace it. I would hope that if and when arbitration is no longer the invariable forum for securities industry disputes, we would learn from past mistakes in deciding what should replace it. The challenge is one that is central to rulemaking governing judicial process in courts the world over: to devise a system that dispenses real justice without making it so cumbersome that it overwhelms the resources of less well-heeled litigants.

It would be a mistake to simply abolish arbitration and toss everything back into the State courts, where 50 jurisdictions would produce a maze of inconsistent results. Instead, Congress should create a federal judiciary dedicated to the resolution of disputes within the financial services industry, something like the Bankruptcy or Tax Courts. If Congress is concerned about burdening the taxpayer with the costs of running these courts, it can assess industry participants.

The enemies of justice – surprise and economics – have been with us for many centuries. Our experience in dispensing justice has evolved over time. This experience means that, while we may not know enough to eliminate these twin demons, we do know how to contain them.

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