



NASAA

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August 2, 2013

The Honorable Keith Ellison  
U.S. House of Representatives  
House Committee on Financial Services  
Washington, DC 20515

Re: Investor Choice Act of 2013

Dear Congressman Ellison:

On behalf of the North American Securities Administrators Association (NASAA),<sup>1</sup> I am writing to applaud you for introducing legislation that prohibits the use of mandatory pre-dispute agreements by broker-dealers and investment advisers that limit investors' ability to pursue recourse in any forum. Your legislation will greatly benefit the public and give investors access to our judicial system. It will further the legislative intent of Congress and ensure that mandatory pre-dispute arbitration provisions are statutorily prohibited under the securities laws.

NASAA has long been concerned with the widespread use of mandatory pre-dispute arbitration clauses in customer contracts used by broker-dealers and, most recently, investment advisers. NASAA believes that investors must have a choice of forum when it comes to resolving disputes with their investment professionals. Investor confidence in fair and equitable recourse is critical to the stability of the securities markets and long-term investments by retail investors. NASAA has argued that participation by "mom and pop" investors in our capital markets, and, by extension, job growth, is directly tied to their level of trust in having a reasonable avenue to seek recovery if they are victimized by securities fraud or other unethical conduct. Investor confidence in the U.S. markets remains low as reflected by a recent Bankrate survey.<sup>2</sup>

Consumer disputes are typically resolved in court or through alternative dispute resolution processes (i.e., negotiation, mediation, arbitration, etc.). Investor disputes against broker-dealers, however, are resolved in only one forum: arbitration administered by the Financial Industry Regulatory Authority (FINRA). Investors are required to submit to FINRA

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<sup>1</sup> The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc. (NASAA) was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

<sup>2</sup> When asked to pick the best way to invest money that would not be needed for the next ten years, investors picked cash, real estate, and even precious metals over the stock market. The findings of the Bankrate survey are available at <http://www.bankrate.com/finance/consumer-index/financial-security-charts-0713.aspx>.

arbitration and denied are access to the courts because almost all broker-dealer contracts require that their customers agree to binding, pre-dispute (i.e., before a dispute or loss is known) arbitration. Increasingly, investment advisers are also requiring that their customers agree to mandatory pre-dispute arbitration as a precondition to becoming a customer of the advisory firm.<sup>3</sup> NASAA considers these “take-it-or-leave-it” clauses (also known as “contracts of adhesion” or “form contracts”) to be detrimental to the public interest.

Section 921 of the Dodd-Frank Wall Street Reform Act of 2010, enacted on July 21, 2010 (the Dodd-Frank Act), was included in response to Congressional concern that mandatory pre-dispute arbitration agreements were unfair to investors.<sup>4</sup> During deliberation, lawmakers observed the following with regard to mandatory pre-dispute arbitration clauses in broker-dealer contracts:

For too long, securities industry practices have deprived investors of a choice when seeking dispute settlement, too. In particular, pre-dispute mandatory arbitration clauses inserted into contracts have limited the ability of defrauded investors to seek redress. Brokerage firms contend that arbitration is fair and efficient as a dispute resolution mechanism.

Critics of mandatory arbitration clauses, however, maintain that the brokerage firms hold powerful advantages over investors. Brokerages often hide mandatory arbitration clauses in dense contract language. Moreover, arbitration settlements generally remain secret, preventing other investors from learning about the performance of a particular brokerage firm.

If arbitration truly offers investors the opportunity to efficiently and fairly settle disputes, then investors will choose that option. But investors should also have the choice to pursue remedies in court, should they view that option as superior to arbitration. For these reasons, H.R. 3817 [the precursor to Section 921] provides the SEC with the authority to limit, prohibit or place conditions on mandatory arbitration clauses in securities contracts.<sup>5</sup>

Section 921 of the Dodd-Frank Act gives the Securities and Exchange Commission (SEC) explicit rulemaking authority to prohibit, condition or limit the use of mandatory pre-

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<sup>3</sup> Letter from Secretary William Francis Galvin of the Commonwealth of Massachusetts to SEC Chairman Elisse B. Walter (Feb. 12, 2013), available at <http://www.sec.state.ma.us/sct/sctarbitration/arbitration-letter.pdf> (citing a Massachusetts Securities Division survey to 710 state-registered Massachusetts investment advisers, which indicated that of the over 50% surveys received, nearly half of the investment advisers included a binding pre-dispute arbitration clause in their advisory contracts).

<sup>4</sup> Congress considered the following concerns about the arbitration process: “high upfront costs; limited access to documents and other key information; limited knowledge upon which to base the choice of arbitrator; the absence of a requirement that arbitrators follow the law or issue written decisions; and extremely limited grounds for appeal.” AARP, letter to Senators Dodd and Shelby, November 19, 2009. See also Senate Committee on Banking, Housing, and Urban Affairs on S. 3217, S. Rep. No. 111-176, at 110.

<sup>5</sup> House Committee on Financial Services on H.R. 3817, H.R. Rep. No. 111-687, Part 1, at 50.

dispute arbitration agreements if it finds that doing so is in the public interest and for the protection of investors. Although Congress gave the SEC an important tool to act in this area, in the three years since the Dodd-Frank Act was passed, the SEC has not exercised its authority to conduct rulemaking or even examine of the impact of mandatory pre-dispute arbitration clauses on investors and the public. Moreover, at least one SEC Commissioner has indicated that the SEC will not be able to undertake a regulatory review of mandatory pre-dispute arbitration clauses before 2014.<sup>6</sup>

In the three years since the Dodd-Frank Act was enacted, NASAA's concern with the widespread use of mandatory pre-dispute arbitration clauses has deepened, fueled in part by one major brokerage firm's decision to expand the scope of its mandatory pre-dispute arbitration clause, thereby further eroding investors' rights to fair recourse. As a consequence of this decision, the need for your legislation has become even more critical.

In late 2011, Charles Schwab & Co. sent over 6.8 million existing account holders monthly account statements accompanied by immediately effective amendments to their account agreements.<sup>7</sup> These amendments included a class action waiver (i.e., denial of the right to participate in class action litigation or on a representative basis). The waiver was also included in new account agreements. Schwab made this decision in light of the Supreme Court's interpretation of the Federal Arbitration Act (FAA) in *AT&T Mobility v. Concepcion*.<sup>8</sup> Interestingly, just a few years prior to issuing this amendment, investors that purchased one of Schwab's mutual funds brought class actions against Schwab, including its broker-dealer affiliate, alleging violation of federal and state securities laws.<sup>9</sup> The court approved a \$200 million settlement, with an average estimated payment to individual investors of \$881, which the court noted offered "substantial recoveries" that "will provide real benefits" to those investors. Had those investors been prohibited from participating in a class action, their potential recovery, even if greater than \$881, would have been too small to warrant pursuing an individual arbitration.<sup>10</sup>

The FAA was never intended to enforce contracts of adhesion, where one party offers terms on a non-negotiated, take-it-or-leave-it basis, such as Schwab's forced arbitration and class action waiver amendment. Legislative history makes clear that the FAA was enacted in 1925 to honor agreements to arbitrate between mutually consenting parties.

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<sup>6</sup> SEC Commissioner Elisse Walter recently stated "It's not going to happen in the next few months or this year because there is so much we have left to do under Dodd-Frank and the JOBS Act – and we have to deal with money market funds and a few other things that by virtue of market interest really are ahead of all of this." Schoeff Jr., Mark, Backed-up SEC won't address mandatory arb any time soon, *InvestmentNews* (May 20, 2013), available at <http://www.investmentnews.com/article/20130520/FREE/130529990>. Ms. Walter has also stated: "I don't know when the commission will find time to do this." Barlyn, Suzanne, SEC review of brokerages use of arbitration not seen in 2013, *Reuters* (May 20, 2013), available at <http://www.reuters.com/article/2013/05/20/us-sec-arbitration-idUSBRE94J0O020130520>.

<sup>7</sup> See Dept. of Enforcement v. Charles Schwab & Co., FINRA Disciplinary Proceeding No. 2011029760201 (Feb. 1, 2012), available at <http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p210893.pdf>

<sup>8</sup> 131 S. Ct. 1740 (2011).

<sup>9</sup> *In re Charles Schwab Sec. Litig.*, No. C08-01510 WHA, 2011 WL 1481424 (N.D. Cal. Apr. 19, 2011).

<sup>10</sup> See discussion of this topic in Black, Barbara and Gross, Jill, *Investor Protection Meets the Federal Arbitration Act* (Sept. 5, 2012), 1 *Stanford Journal of Complex Litigation* (2012 Forthcoming).

Legislative history reveals that Congress intended the Federal Arbitration Act to cover disputes between merchants of approximately equal strength, Arbitration of Interstate Commercial Disputes: Hearing of S. 1005 and H.R. 646 Before the J. Comm. of Subcomms. on the Judiciary, 68th Cong. 10 (1924), but not involving disputes with workers, Sales and Contracts to Sell in Interstate and Foreign Commerce, and Federal Commercial Arbitration: Hearing on S. 4213 and S. 4214 Before a Subcomm. of the S. Comm. on the Judiciary, 67th Cong. 9, 14 (1923), or disputes where the arbitration agreement could be considered an adhesion contract, Arbitration of Interstate Commercial Disputes: Hearing of S. 1005 and H.R. 646 Before the J. Comm. of Subcomms. on the Judiciary, 68th Cong. 15 (1924).<sup>11</sup> As Representative Graham noted in the House floor debate in 1924, “[t]his bill simply provides for one thing, and that is to give an opportunity to enforce an agreement in commercial contracts and admiralty contracts—an agreement to arbitrate, when voluntarily placed in the document by the parties to it.” 68 Cong. Rec. 1931 (1924).<sup>12</sup>

Unfortunately, the reach of the FAA has been expanded by the Supreme Court over the last twenty years to apply in contracts between parties of unequal bargaining power.<sup>13</sup> In the instance of Schwab seeking to expand its arbitration clauses to include class action waivers, FINRA instituted a disciplinary action against Schwab for the violation of its member rules which preserve judicial class actions as an alternative to arbitration.<sup>14</sup> However, to NASAA’s disappointment, in February a FINRA Hearing Panel determined that those rules and, by extension, the agreement between Schwab and FINRA to abide by those rules, could not be enforced under *Concepcion*.<sup>15</sup> FINRA has appealed the Hearing Panel ruling; however, if Schwab is successful in the appeal, it is very likely that every broker-dealer and investment adviser will follow suit and include class action waiver language in their customer agreements.<sup>16</sup> Even publicly-traded companies may attempt to insulate themselves from liability by including

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<sup>11</sup> House Committee on the Judiciary, Report on Activities During 111th Congress, H.R. Rep. No. 111-712, at footnote 128.

<sup>12</sup> Id. at footnote 126.

<sup>13</sup> See *American Express Co. v. Italian Colors Rest.*, Slip Op. No. 12-133 (S. Ct. June 20, 2013) (“AMEX III”) (holding that a group of merchants was bound by individual arbitration agreements with American Express even if a class action was the only way to make their claim economically viable). The decision, which supported the enforceability of an arbitration agreement’s class action waiver, has sparked mounting outrage among consumer advocacy and public interest groups.

<sup>14</sup> See footnote 6.

<sup>15</sup> NASAA has argued that as the agency chosen by Congress to oversee FINRA arbitration, the SEC’s exercise of its specific authority under Section 921 of the Dodd-Frank Act supersedes the FAA’s general provisions. Letter from NASAA to SEC Chairman Mary Jo White (May 3, 2013), available at <http://www.nasaa.org/wp-content/uploads/2011/07/NASAA-Letter-to-SEC-on-Arbitration-and-Class-Action-Waivers.pdf>.

<sup>16</sup> As Secretary Galvin has stated “This ruling is akin to giving every rogue broker-dealer the green light to steal from their customers in small dollars amounts.” Letter from Secretary William Francis Galvin of the Commonwealth of Massachusetts to SEC Chairman Elisse B. Walter (Feb. 26, 2013), available at <http://www.sec.state.ma.us/sct/sctschwabarb/Schwab-letter.pdf>.

mandatory arbitration and class action waiver language into their governing documents.<sup>17</sup>

**For these reasons, the time is ripe for Congress to advance the underlying intent and spirit of Section 921 of the Dodd-Frank Act by amending the securities laws as applicable to broker-dealers and investment advisers to statutorily prohibit the use of any mandatory pre-dispute agreement that erodes class action or other investor right to seek redress in the most appropriate forum of his or her choosing—The Investor Choice Act of 2013 accomplishes these goals.**

Without this legislation, the FINRA Hearing Panel's decision in the disciplinary action against Schwab poses an imminent threat to investors' ability to seek redress, particularly for small dollar claims.<sup>18</sup> In other words, the practical effect of the Hearing Panel's decision could be to eliminate the ability of investors to bring or participate in class actions which is the only viable means for most small investors to recoup their loss. As the Seventh Circuit Court of Appeals has correctly observed "[t]he realistic alternative to a class action is not 17 million individual suits, but zero individual suits, as only a lunatic or a fanatic sues for \$30."<sup>19</sup> The high cost of attorneys' fees alone makes adequate representation in a FINRA arbitration, particularly against a large and sophisticated brokerage firm, insurmountable in light of the potential dollar award for a small investor. Even the SEC has advised brokerage firms that "form" contracts requiring mandatory pre-dispute arbitration are against public policy.<sup>20</sup>

Restoring protections for Americans with limited means to invest is even more critical in light of changes enacted as part of the Jumpstart Our Business Startups Act (JOBS Act), which became law on April 5, 2012. The JOBS Act established a mechanism for crowdfunding and loosened restrictions on advertising and solicitation of private securities offerings to small investors. NASAA anticipates that these provisions of the JOBS Act will lead to an increase in very small investments, and if these investors are forced to waive their right to participate in class actions, they will be left with no economically viable remedy when they are defrauded.

Indeed, without a class action vehicle, many claims and potentially harmful activity will go unnoticed (i.e., arbitration cases are private, unpublicized proceedings), thus resulting in windfalls to violators. Your bill ensures that investors will not be forced into arbitration or any other forum that could foreclose their ability to obtain relief. NASAA strongly supports the Investor Choice Act of 2013 and thanks you for recognizing that the inclusion of mandatory pre-dispute agreements in broker-dealer and investment adviser contracts undermines investor faith in the markets that Congress is trying to jump start. This legislation will ensure that investors

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<sup>17</sup> See source cited supra note 9, at pgs. 7-9 (discussing the 2012 attempt by Carlyle Group LP to amend its initial public offering registration statement to require arbitration of investor disputes and recent attempts by shareholders to include in proxy statements of four publicly traded companies bylaw amendments that would require arbitration, and prohibition on class actions, of all shareholder claims including securities law violations).

<sup>18</sup> Amicus Curiae Brief of NASAA at 14, Dept. of Enforcement v. Charles Schwab & Co., FINRA Disciplinary Proceeding No. 2011029760201 (Feb. 1, 2012).

<sup>19</sup> *Carnegie v. Household Int'l, Inc.*, 376 F.3d 656, 661 (7th Cir. 2004).

<sup>20</sup> "Requiring the signing of an arbitration agreement without adequate disclosure as to its meaning and effect violates standards of fair dealing with customers and constitutes conduct that is inconsistent with just and equitable principles of trade." Notice to Broker-Dealers Concerning Clauses in Customer Agreements which Provide for Arbitration of Future Disputes," 1979 WL 174165 (S.E.C. Release No. 34-15984), p. 4.

have a meaningful choice and an unencumbered right to seek redress in the appropriate and desired forum.

For the reasons summarized above, NASAA applauds you for introducing the Investor Choice Act of 2013, and we look forward to working with you to ensure the bill's timely enactment.

Sincerely,

A handwritten signature in black ink, appearing to read "A. Heath Abshure". The signature is written in a cursive, flowing style.

A. Heath Abshure  
NASAA President & Arkansas Securities Commissioner