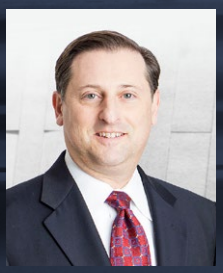
Allowing Forced Arbitration Clauses in IPOs Would Lead to End of Securities Law Remedies



DANIEL S. SOMMERS
PARTNER
202.408.4600
dsommers@cohenmilstein.com
V-CARD

When SEC Commissioner Michael Piwowar suggested last July that the Commission might be willing to consider allowing companies going public to force shareholders to resolve disputes through arbitration, and not in open court, the news initially reverberated largely in specialized circles. After all, the SEC, Congress and the courts have enshrined the right of private action—the ability to seek financial redress under federal and state securities laws—as a vital tool for investors. Then, in January, Bloomberg reported that the SEC itself was "laying the groundwork" to permit companies applying for SEC approval of initial public offerings to include such "mandatory arbitration" provisions in their charters. The news that the radical idea had spread far beyond one of the five Commission members drew swift and strong responses from institutional investors and their allies. Those condemning the proposal include another member of the Commission, and the SEC's own investor advocate, who called it "draconian." Forced to respond, SEC Chair Jay Clayton has limited himself to saying he was "not anxious" to pursue the rule, hardly a comfort to investors who understand that forced arbitration would vastly constrain their ability to recover money lost to securities fraud. Worse, Chairman Clayton recently refused even to commit that any consideration of such a radical change would be subject to the rigorous and transparent processes required by federal law. At the height of the debate, Cohen Milstein Partner Daniel Sommers participated in a teleconference organized by the Council of Institutional Investors, the nation's preeminent shareholder education and advocacy organization. The following article is adapted from his opening remarks at the February 21 teleconference. Sommers was elected chair of the CII's Markets Advisory Council last month.

"STRIPPING AWAY THE RIGHT OF SHAREHOLDERS TO BRING A CLASS ACTION LAWSUIT SEEMS TO ME DRACONIAN AND ... COUNTERPRODUCTIVE."

RICK FLEMING
SEC'S INVESTOR ADVOCATE

Adopting Commissioner Piwowar's proposal to permit companies to impose mandatory arbitration provisions in connection with their IPOs would rapidly lead to the end of meaningful securities law remedies for investors.

This proposal in fact presents as great a threat to investor rights as anything I have seen in the past thirty years—ranking with challenges in the Supreme Court to the fraud-on-the-market doctrine underpinning securities class actions. To put it bluntly, Commissioner Piwowar's proposal is calculated to and would in fact deny investors their rights under the securities laws in almost all situations.

TO PUT IT BLUNTLY, COMMISSIONER PIWOWAR'S PROPOSAL IS CALCULATED TO AND WOULD IN FACT DENY INVESTORS THEIR RIGHTS UNDER THE SECURITIES LAWS IN ALMOST ALL SITUATIONS.

> *[N]ow – when SEC enforcement is hamstrung by budgetary and legal limits—is hardly the time to be thinking about depriving shareholders of their day in court.*
>
> COMMISSIONER
> ROBERT J. JACKSON, JR.

While the proposal by Commissioner Piwowar presently is restricted to use by newly formed public companies, it would inevitably spread over time as companies with such provisions make up an increasing share of listed companies. Further, the scope of forced arbitration provisions would certainly morph beyond companies applying for IPOs, as existing public companies, emboldened by the precedent, will find ways to amend their charters or bylaws to force investors out of court and into arbitration proceedings. The temptation for public companies to avail themselves of what effectively is a "get-out-of-jail-free card" by restricting investors' ability to use both the court system and the class-action mechanism will be irresistible.

So why would this mark the beginning of the end of effective remedies for investors? The answer is that forced arbitration would compel investors to participate in a process that undermines all of the critical elements of current securities litigation that makes that process a fair and economically rational option for investors.

Currently, investors have the right to sue under federal securities laws when they believe they were misled in connection with the purchase of a security. This right to go to court is longstanding and essential. In fact, on numerous occasions the SEC and the Supreme Court have said that private enforcement of the federal securities laws is a vital supplement to the SEC's investor protection mission.

(Editor's Note: As mentioned above, recent critics of the mandatory arbitration proposal include the SEC's own Investor Advocate, Rick Fleming. In his February 24 speech, which highlighted similar issues as Sommers does here, Fleming said that "stripping away the right of shareholders to bring a class action lawsuit seems to me draconian and, with respect to promoting capital formation, counterproductive." Two days later, newly appointed Commissioner Robert J. Jackson Jr. signaled his opposition to a group of investors, saying: "[Now —when SEC enforcement is hamstrung by budgetary and legal limits—is hardly the time to be thinking about depriving shareholders of their day in court." In March, Democrats belonging to the House Financial Services Committee wrote Chair Clayton that they "strongly oppose any effort to reverse the Commission's longstanding position that such forced arbitration provisions violate Federal securities law." Even former SEC Chair Harvey Pitt, who has devoted much of his career to defending companies accused of securities fraud, said forced arbitration "is on the outer edges" and advised current Chair Clayton to put it "on the back burners.")

Our court system today offers investors a range of litigation options. Investors may choose to bring a case on their own behalf in court or seek to be a lead plaintiff in a class action, where a group of investors can seek redress at once. Importantly, because class actions automatically include all similarly harmed shareholders, investors can also remain as uninvolved members of a class but still share in any recovery.

Specifically, investors now have the following rights:

- The right to seek and obtain evidence before trial both from the defendants and from people and entities that are not parties to the case—including documents and testimony under oath from witnesses located anywhere in the United States and, if needed, in many other countries.
- The right, enforceable by a judge, to obtain evidence after litigation has commenced.
- The right to litigate their claims in a public forum and to bring corporate wrongdoing to light, which serves as a deterrent against future misconduct.
- The right to have their claims adjudicated by an impartial judge and have factual disputes resolved by a jury.
- The right to appeal any adverse decisions to a higher court.
- The right to proceedings governed by a clear set of well-established rules, including the Federal Rules of Civil Procedure and the Federal Rules of Evidence.

- The right to have any judgments or orders enforced by a judge, including those relating to collection of a judgment.
- And, of critical importance, the right to utilize the class action process, which enables investors with losses too small to justify the significant expense of litigation to band together to obtain relief for themselves and all similarly aggrieved investors.

Forced arbitration will undo each of these rights.

In arbitration, investors have very limited ability to obtain pre-trial evidence and arbitrators have limited ability to enforce orders—especially with respect to parties who are not part of the arbitration.

In arbitration, investors lose their constitutional right to trial by a jury and the panel of arbitrators may include individuals with pro-industry bias.

The procedural rules that apply in Court do not necessarily apply in arbitration. Investors do not have access to appellate courts as they would in a court proceeding. Moreover, arbitration proceedings are secretive and held outside of the public eye.

Most importantly, class or other collective actions are generally not available in arbitration, and any arbitration provisions that will be drafted under Commissioner Piwowar's proposal will almost certainly contain class action waivers, which will bar investors from initiating or participating in a class action.

This means that investors will be forced to litigate their own claims alone in arbitration, and to bear the costs of that litigation alone. Such a system is simply not economically rational for investors, except in the rarest cases where an investor has losses in the many tens or hundreds of millions of dollars. And even then, investors would be forced to pursue their claims in a process that lacks the procedural and substantive fairness currently afforded them by our court system.

So all this means that securities litigation in a forced-arbitration world would be economically irrational for mid-sized and small investors, and only possible for even the largest investors in the most unusual of circumstances.

As a result, I would expect that if this proposal is adopted we will see over a relatively short time that the number of securities cases that are filed in court will dwindle to insignificance. And for those few investors who find their way into arbitrations, they will be met by a forum that is fundamentally ill-equipped to properly and effectively adjudicate securities cases. ■

Daniel S. Sommers, a Cohen Milstein partner, is a member of the firm's Executive Committee and co-chair of its Securities Litigation & Investor Protection practice group.

FORCED ARBITRATION: ACTION AND REACTION

JULY 2017
SEC Commissioner Michael Piwowar tells the Heritage Foundation: "For shareholder lawsuits, companies can come to us to ask for relief to put in mandatory arbitration into their charters."

NOVEMBER 2017
President Trump approves a Congressional resolution repealing a rule that would have stopped financial firms from requiring consumers to use arbitration.

JANUARY 26, 2018
Bloomberg publishes an article saying the SEC is "laying the groundwork" to consider allowing companies going public to include forced arbitration provisions in their charters.

JANUARY 29, 2018
The Council of Institutional Investors expresses its concern to the SEC, urging the Commission to continue opposing such measures, as it has for three decades.

FEBRUARY 6, 2018
Testifying before the Senate Banking, Housing and Urban Affairs Committee, SEC Chair Jay Clayton says that, while he "can't pre-judge" future issues, he is "not anxious to see changes" to current rules.

FEBRUARY 24, 2018
In a speech, SEC Investor Advocate Rick Fleming calls efforts to introduce mandatory arbitration in publicly traded companies "draconian" and "counterproductive" to promoting capital formation.

FEBRUARY 26, 2018
SEC Commissioner Robert Jackson says forced arbitration would "radically" benefit corporate insiders by stripping investors' "right to their day in court."

MARCH 2018
Democrats on the House Financial Services Committee urge the SEC to "reaffirm its longstanding position that forced arbitration provisions ... harms the public interest and violates the anti-waiver provisions of the Federal securities laws."