DIFFICULT, DUPLICATIVE AND WASTEFUL?: THE NASD'S PROHIBITION OF CLASS ACTION ARBITRATION IN THE POST-*BAZZLE* ERA

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INTRODUCTION

"Classwide arbitration, as Sir Winston Churchill said of democracy, must be evaluated, not in relation to some ideal but in relation to its alternatives."[1] Though arbitration is concededly far from perfect, it has certain procedural advantages and is often a more favorable mechanism of dispute resolution than litigation. In particular, the National Association of Securities Dealers (NASD)[2] employs arbitration to resolve *any* disputes arising in connection with the business of its members.[3] However, the NASD has carved out a narrow exception to this general rule, whereas actions pursued on a classwide basis must be litigated in the courts rather than resolved in arbitration.[4]

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[1] Keating v. Superior Court of Alameda County, 645 P.2d 1192, 1209 (Cal. 1982).

[2] The NASD is the leading private sector regulator of America's securities industry and operates the largest securities dispute resolution forum in the world, and handles ninety percent of security industry arbitrations and mediations in the United States. *See* NASD, What is Dispute Resolution?, http://www.nasd.com/ArbitrationMediation/NASDDisputeResolution/WhatisDisputeResolution/index.htm (last visited Nov. 27, 2006); *see also* DAVID E. ROBBINS, 1 SECURITIES ARBITRATION PROCEDURE MANUAL xiv (5th ed. 2005) ("NASD Dispute Resolution, Inc. now administers 95% of all securities arbitrations."); Guy Nelson, *The Unclear "Clear and Unmistakable" Standard: Why Arbitrators, Not Courts, Should Determine Whether Securities Investor's Claim Is Arbitrable*, 54 VAND. L. REV 591, 609-10 (2001) ("the dominance of the NASD in conducting securities arbitration must be acknowledged.").

[3] NAT'L ASS'N OF SEC. DEALERS, NASD MANUAL § 10301(a) (last amended June 11, 2001); *see also* ROBBINS, *supra* note 2, § 1-1 ("almost all disputes between a customer and a broker must now be arbitrated.").

[4] Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change Relating to the Exclusion of Class Actions From Arbitration Proceedings, Exchange Act Release No. 34-31371, 57 Fed. Reg. 52659 (Nov. 4, 1992); NAT'L ASS'N OF SEC. DEALERS, NASD MANUAL § 10301(d) (last amended June 11, 2001) (Code of Arbitration Procedure).

> (1) A claim submitted as a class action shall not be eligible for arbitration under this Code at the Association.

This Note argues that the NASD should provide an arbitral forum for the resolution of class action claims, as it does for virtually all other disputes.[5]

The sharp retreat from its extensive mandatory arbitration policy occurred in 1992, when the NASD promulgated Rule 10301(d) (Exclusionary Rule). The Exclusionary Rule provides that arbitration is wholly unavailable for class action claimants.[6] The NASD adopted this prohibition based on a suggestion of the then Chairman of the Securities and Exchange Commission (SEC), David Ruder, who believed that "the judicial system has already developed procedures to manage class action claims" and that the arbitration of class action claims by self regulatory organizations (SROs)[7] would be "difficult, duplicative and wasteful."[8]

> (2) Any claim filed by a member or members of a putative or certified class action is also ineligible for arbitration at the Association if the claim is encompassed by a putative or certified class action filed in federal or state court, or is ordered by a court to an arbitral forum not sponsored by a self-regulatory organization for classwide arbitration. However, such claims shall be eligible for arbitration in accordance with paragraph (a) or pursuant to the parties' contractual agreement, if any, if a claimant demonstrates that it has elected not to participate in the putative or certified class action or, if applicable, has complied with any conditions for withdrawing from the class prescribed by the Court.
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> (3) No member or associated person shall seek to enforce any agreement to arbitrate against a customer, other member or person associated with a member who has initiated in court a putative class action or is a member of a putative or certified class with respect to any claims encompassed by the class action unless and until: (A) the class certification is denied; (B) the class is decertified; (C) the customer, other member or person associated with a member is excluded from the class by the Court; or (D) the customer, other member or person associated with a member elects not to participate in the putative or certified class action or, if applicable, has complied with any conditions for withdrawing from the class prescribed by the Court.
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> (4) No member or associated person shall be deemed to have waived any of its rights under this Code or under any agreement to arbitrate to which it is party except to the extent stated in this paragraph.

Id.

[5] *See supra* note 3. Disputes invoking the following statutes have been deemed arbitrable under the Federal Arbitration Act, 9 U.S.C. § 1 (2000), and could be arbitrated at the NASD on an individual basis: Sherman Act, 15 U.S.C. §1 (2000), s*ee, e.g.*, *In re* Instinet Corp., No. 108720/03, 2003 WL 22721404 (N.Y. Sup. Ct. Nov. 14, 2003); Securities Exchange Act of 1933, 15 U.S.C. § 77a (2000), s*ee, e.g.*, Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 626 (1985); Securities Act of 1934, 15 U.S.C. § 78a (2000), s*ee, e.g.*, Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 232 (1987); Fair Labor Standards Act, 29 U.S.C. §§ 201-219 (2000), s*ee, e.g.*, Kuehner v. Dickinson & Co., 84 F.3d 316 (9th Cir. 1996); Age Discrimination in Employment Act, 29 U.S.C. § 621 (2000), s*ee, e.g.*, Haskins v. Prudential Ins. Co. of Am., 230 F.3d 231 (6th Cir. 2000); and Racketeering Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961-1968 (2000), s*ee, e.*g., *Shearson*, 482 U.S. at 222.

[6] *See supra* note 4.

[7] *See infra* note 49.

[8] Letter from David S. Ruder, Chariman of the Securities and Exchange Commission, to all Self Regulatory Organizations (July 13, 1988); *see* Self-Regulatory Organizations; Notice of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to

There are two fundamental reasons why the NASD should abrogate its Exclusionary Rule. First, the NASD's class action arbitration prohibition is contrary to the emphatically pro-arbitration policy of the Federal Arbitration Act (FAA).[9] The legislative intent of the FAA was to provide a procedural mechanism for the enforcement of arbitration agreements, to promote a more expeditious and economical alternative to litigation, and to reduce the congestion of the courts.[10] For decades, the Supreme Court has mandated a broad application of arbitration as a matter of federal law,[11] and in 2003 interpreted the FAA to affirmatively allow for class action arbitration.[12] In promulgating Rule 10301(d), the NASD took a stance inconsistent with the policy of the FAA by reducing the availability of a legally viable arbitration procedure.

Second, the NASD's reasoning that class action arbitration would be "difficult, duplicative and wasteful" is flawed.[13] Although arbitration is admittedly not a perfect system, credible empirical data suggests that arbitration provides substantial advantages to claimants as compared to litigation.[14] The Securities Exchange Act of 1934

Improvements in the NASD Code of Arbitration Procedure, Exchange Act Release No. 34-30882, 51 SEC-Docket 1340 (July 1, 1992); *see also* Notice of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Improvements in the NASD Code of Arbitration Procedure, 57 Fed. Reg. 52661 (Nov. 4, 1992).

9 9 U.S.C. §§ 1-14 (2000); *see generally infra* Part II.A-B.

10 Lindsay R. Androski, *A Contested Merger: The Intersection of Class Actions and Mandatory Arbitration Clauses*, 2003 U. CHI. LEGAL F. 631, 635 ("Representative Mills of New York, who introduced the original bill in the House, explained that the FAA 'provides that where there are commercial contracts and there is disagreement under the contract, the court can enforce an arbitration agreement in the same way as other portions of the contract.' Similarly, the chairman of the New York Chamber of Commerce testified before the Senate that the Act would 'enable business men to settle their disputes expeditiously and economically, and (would) *reduce the congestion in the Federal and State courts*.' A Senate Judiciary Committee Report supporting the legislation explained that arbitration provides benefits to both consumers and businesses through speedier resolution and lower costs: 'The desire to avoid the delay and expense of litigation persists . . .'") (emphasis added); *see also* 65 CONG. REC. H11080 (June 6, 1924) (statement of Rep. Mills); H.R. REP. NO. 68-96, at 1 (1924); *Sales and Contracts to Sell in Interstate and Foreign Commerce, and Federal Commercial Arbitration: Hearing on S 4213 and 4214 before a Subcomm. of the Committee on the Judiciary*, 67th Cong, 4th Sess. 2 (1923).

11 *See generally infra* Part II.B.

12 *See infra* Part III.E.

13 *See infra* Part IV.B.2.

14 NAT'L ARBITRATION FORUM, THE CASE FOR PRE-DISPUTE ARBITRATION AGREEMENTS: EFFECTIVE AND AFFORDABLE ACCESS TO JUSTICE FOR CONSUMERS: EMPIRICAL STUDIES AND SURVEY RESULTS 1 (2004), *available at* http://www.adrforum.com/rcontrol/documents/ResearchStudiesAndStatistics/2004EmpiricalStudies.pdf (finding that "[s]eventy-eight percent of trial attorneys find arbitration faster than lawsuits," "[e]ighty-six percent of trial attorneys find arbitration costs are equal to or less expensive than lawsuits," "[s]eventy-eight percent of business attorneys find that arbitration provides faster recovery than lawsuits," "[e]ighty-three percent of business attorneys find arbitration to be equally or more fair than lawsuits," "[i]ndividuals prevail at least slightly more often in arbitration than through lawsuits," "[m]onetary relief for individuals is slightly higher in arbitration than in lawsuits," "[a]rbitration is approximately 36% faster than a lawsuit," "[i]ndividuals receive a greater percentage of the

(Exchange Act)[15] requires that the NASD, in promulgating its rules, must protect investors and advance the public interest.[16] Arbitration of securities claims is often better suited to protect the interests of class action claimants.[17] Therefore, the NASD, under the Exchange Act, has the statutory authority to promulgate new regulations requiring arbitration of class claims without difficulty.[18]

Part I of this Note will briefly explain what arbitration is and how it differs from litigation. Part II will discuss the background of arbitration jurisprudence and policy in the United States. Part III will discuss the importance of class actions, the historical court split with respect to class action arbitrability, and the Supreme Court's reconciliation of the split in *Green Tree Financial Corp. v. Bazzle*[19] in 2003. Part IV will discuss the NASD's Exclusionary Rule and will argue that the NASD should redraft its policy because (1) the Exclusionary Rule conflicts with the pro-arbitration policy of the FAA and (2) the availability of class action arbitration is in the public interest and would not be "difficult, duplicative and wasteful." Part V of this Note will propose how the NASD might change its policy to a stance consistent with the policy of the FAA and in the best interest of the public.

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relief they ask for in arbitration versus lawsuits," "[n]inety-three percent of consumers using arbitration find it to be fair," "[c]onsumers prevail 20% more often in arbitration than in court," "[i]n securities actions, consumers prevail in arbitration 16% more than they do in court," and that "[s]ixty-four percent of American consumers would choose arbitration over a lawsuit for monetary damages.").

15 15 U.S.C. § 78a (2000).

16 The SROs are empowered under the Exchange Act to prescribe rules that are in the public interest. 15 U.S.C. § 78o-3(a) (2000).

> Registration; application. An association of brokers and dealers may be registered as a national securities association pursuant to subsection (b) of this section, or as an affiliated securities association pursuant to subsection (d) of this section, under the terms and conditions hereinafter provided in this section and in accordance with the provisions of section 19(a) of this title, by filing with the Commission an application for registration in such form as the Commission, by rule, may prescribe containing the rules of the association and such other information and documents as the Commission, by rule, may prescribe as necessary or appropriate *in the public interest* or *for the protection of investors*."

Id. (emphasis added).

17 *Id.*; *see also infra* Part IV.B.2.

18 15 U.S.C. § 78o-3(a) (2000).

19 539 U.S. 444 (2003). The *Bazzle* decision did not completely reconcile the split. In *Bazzle*, there was no clear majority opinion with respect to the availability of class arbitration where the disputed agreement is silent. The majority did, however, determine that classwide arbitration is available under the FAA where the parties agreed to provide for it. Further, the Court held that the arbitrability of the class action is a question for the arbitrator to decide, rather than the courts. *Id.*

I. WHAT IS ARBITRATION?

Arbitration is an ancient and venerable practice that has existed, in concept, since 700 B.C.E.[20] In contemporary American society, arbitration offers a prompt and inexpensive means of resolving complicated issues[21] and is often a more favorable method of dispute resolution between parties than litigation.[22] Functionally, arbitration is a procedural device for dispute resolution, whereby parties voluntarily submit their arguments to an impartial third party and agree in advance to be bound by the third party's ruling.[23] Although arbitration is like litigation in that it is an adversarial process presided over by a binding and neutral third party, it differs in many other ways.[24]

A. *Arbitration Versus Litigation*

According to an empirical survey taken by the National Arbitration Forum, the majority of attorneys polled found that, in comparison to litigation, arbitration is *faster, less expensive, fairer for individuals, awards greater damages to claimants, offers better chances for recovery to individuals* and *is preferred over litigation by consumers*.[25]

There are two defining characteristics that distinguish arbitration from litigation.[26] First, arbitration is generally binding.[27] Unlike litigation, arbitration decisions are only appealable in very limited circumstances.[28] Second, arbitration is a consensual process, whereby

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[20] *See, e.g.*, DEREK ROEBUCK, EVEN GODS NEEDED ARBITRATION: ANCIENT GREEK ARBITRATION (2001).

[21] *See* NASD, What is Dispute Resolution?, http://www.nasd.com/ArbitrationMediation/NASDDisputeResolution/WhatisDisputeResolution/index.htm (last visited Nov. 27, 2006)

[22] *See* H.R. REP. NO. 96, 68th Cong., 1st Sess., 1, 2 (1924) ("[T]here is so much agitation against the costliness and delays of litigation. These matters can be largely eliminated by agreements for arbitration, if arbitration agreements are made valid and enforceable.").

[23] C. EDWARD FLETCHER, ARBITRATING SECURITIES DISPUTES 2 (1990); *see also* AM. ARBITRATION ASS'N, INTRODUCTORY GUIDE TO AAA ARBITRATION AND MEDIATION 2, http://www.adr.org/si.asp?*id*=2216 (last visited Nov. 27, 2006) ("Arbitration is a submission of a dispute to one or more impartial persons for a final and binding decision. The arbitrators may be attorneys or business persons with expertise in a particular field. The parties control the range of issues to be resolved by arbitration, the scope of the relief to be awarded and many of the procedural aspects of the process. Arbitration is less formal than a court trial. The hearing is private."); *see also* NASD, Arbitration & Mediation, http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=883 (last visited Nov. 27, 2006).

[24] FLETCHER, *supra* note 23, at 848-49 ("Much like litigation, arbitration is characterized by trial-like adversarial confrontation, but it is conducted privately and employs more relaxed rules of evidence and procedure than litigation.").

[25] *See supra* note 14.

[26] FLETCHER, *supra* note 23, at 2.

[27] *Id.*

[28] NAT'L ASS'N OF SEC. DEALERS, NASD MANUAL § 10330(b) (last amended Aug. 6, 1997)

parties voluntarily agree to arbitrate disputes before they arise.[29]

In addition to the foregoing distinctions, arbitration is notably different from litigation in the following ways. Arbitration is a private hearing,[30] and thus principals of res judicata and collateral estoppel do not always apply.[31] The arbitral panel rarely delivers its decision with a thorough description of the facts of the case or a textual reasoning for the ruling.[32] Therefore, if an issue is resolved once in arbitration, it would have to be resolved again if that same issue arose in a later proceeding.[33] For example, in actions where numerous claimants are similarly situated, each individual claimant would be forced to resolve their dispute against the same corporate defendant who often has superior resources.[34] This is disadvantageous for claimants, especially if the class action device is not available.[35]

In arbitration, at least one member of the panel is usually an expert in the field which the dispute concerns.[36] This is advantageous for both parties to a dispute, because there is a level of sophistication on the panel that would not exist with a typical jury.[37] As well, in litigation, finding an industry expert to testify against a particular broker-dealer's practices can be very difficult.[38] Since experienced industry representatives serve on the panel, the arbitrators do not need to be educated as would a judge or jury.[39] This superior knowledge reduces the time required to proceed in arbitration and makes the process more efficient.

Typically, by submitting a claim to arbitration, parties are precluded from pursuing the same claim in court.[40] Prior to the

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("Unless the applicable law directs otherwise, all awards rendered pursuant to this Code shall be deemed final and not subject to review or appeal."); *see also* ROBBINS, *supra* note 2, § 1-12.

29 *See* FLETCHER, s*upra* note 23, at 2.

30 Arbitration hearings at the NASD must now be recorded "by stenographic reporter or a tape, digital, or other recording." NAT'L ASS'N OF SEC. DEALERS, NASD MANUAL § 10326(a) (last amended Aug. 23, 2006).

31 *See* Keating v. Superior Court of Alameda County, 645 P.2d 1192, 1207 (Cal. 1982) ("Because the principles of res judicata and collateral estoppel do not apply in arbitration proceedings, any issue resolved against a party . . . in one arbitration proceeding would have to be decided anew in a subsequent arbitration . . . .").

32 ROBBINS, *supra* note 2, § 1-21. Arbitration awards are publicly available and provide some detail regarding allegations and defenses asserted. However, arbitrators do not have to state the reasoning for their decisions.

33 *See Keating*, 645 P.2d at 1207.

34 *Id.*

35 *Id.*

36 Securities Industry Association—A Review of the Securities Arbitration System, http://www.sia.com/testimony/2005/sec-arbitration3-17-05.html (last visited Nov. 28, 2006) (testimony of President of the Securities Industry Association Marc E. Lackritz before the Committee on Financial Services in the House of Representatives on March 17, 2005).

37 *Id.*

38 ROBBINS, *supra* note 2, §1-4.

39 *Id.*

40 *See* 9 U.S.C. § 3 (2000):

availability of classwide arbitration, defense attorneys would routinely invoke this preclusive rule in order to defeat class action complaints.[41] In the event of a class claim, the defense would compel each member of the class action to individual arbitration and force decertification of the class. Under this framework, claimants were deprived of any forum to pursue class claims.[42] Following the Supreme Court's ruling in *Green Tree Financial Corp. v. Bazzle*[43] in 2003, this is no longer the practice.[44]

Though it is substantively different than litigation, arbitration is an equally valid forum of dispute resolution. United States Supreme Court Justice Sandra Day O'Connor has described the arbitral process as "the functional equivalent of the courts,"[45] which provides the claimant equal protection with respect to any substantive or statutory rights.[46]

B. *Securities Arbitration and the NASD*

In 1817, Wall Street traders implemented a constitution to govern their fledgling securities industry.[47] Puruant to this document, the industry's "founding fathers" formally declared arbitration to be the required method of dispute resolution among stock traders.[48]

Today, there are six dominant securities organizations in the United States sponsoring arbitration,[49] with the NASD as the largest

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> If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.

Id.

41 *See, e.g.*, Cari Katrice Dawson, *Arbitration Clauses and Class Actions: After Greeen Tree v. Bazzle, Are these Clauses the Silver Bullet to Stop Class Actions?*, ALTSON+BIRD LLP: CLASS ACTION ADVISORY, Dec. 2004, at 1.

42 *Id.*

43 539 U.S. 444 (2003).

44 *Id.*; *see also* Dawson, *supra* note 41.

45 Shearson/Am. Express v. McMahon, 482 U.S. 220, 257 n.14 (1987) (citation omitted).

46 *Id.*

47 *See* FLETCHER, *supra* note 23, at 27-28. This constitution included a provision that "all questions of dispute in the purchase and sale of stocks shall be decided by a majority of the Board."

48 *Id.* The newly promulgated regulations contained the first arbitration clause in the history of the securities industry, requiring that all disputes arising out of stock trades must be decided by a NYSE-run board.

49 *Id.* at 3-5. The six dominant organizations are the National Association of Securities Dealers (NASD), the New York Stock Exchange (NYSE), the American Stock Exchange (Amex), the Chicago Board Options Exchange (CBOE), the Municipal Securities Rulemaking Board (MSRB), and the American Arbitration Assocation (AAA). The NASD, NYSE, Amex, CBOE, and the MSRB are all members of the Securities Industry Conference on Arbitration

among them.[50] The NASD is a non-profit organization with self regulatory authority under the Exchange Act.[51] According to the Exchange Act, the NASD may adopt its own procedural rules, but must first obtain approval from the SEC.[52] The SEC will accept an SRO rule if it complies with the provisions of the Exchange Act,[53] which require that the rule is "in the public interest" or "for the protection of investors."[54]

Virtually all American broker-dealers are members of the NASD and agree to abide by its rules as a condition of membership.[55] Under the Exchange Act, the NASD has oversight responsibility for the National Association of Securities Dealers Automated Quotation system (NASDAQ)[56] and over-the-counter securities markets in the United States.[57]

The NASD roster of arbitrators is filled with approximately 7,000 arbitrators who are carefully selected from diverse professions and backgrounds.[58] Arbitrators are approved only after passing a complete background check, comprehensive training, and various written tests.[59] Parties to an arbitration may choose a neutral arbitrator from a

(SICA) and are all regulated by the SEC. The AAA is the only major arbitration organization not affiliated with SICA or subject to SEC oversight. SICA was established in April 1977 as a result of an SEC suggestion that a central permanent task force was necessary to examine issues involving securities arbitration. SICA promulgated the Uniform Code of Arbitration (UCA) which is adopted voluntarily by the SICA members, but with slight variations from SRO to SRO. *Id.*

50 *See supra* note 2.

51 *See supra* note 16.

52 FLETCHER, *supra* note 23, at 6. SEC oversight power is derived from the Exchange Act, 15 U.S.C. § 78s-(b)(1) (2000) ("Each self-regulatory organization shall file with the Commission, in accordance with such rules as the Commission may prescribe, copies of any proposed rule or any proposed change in, addition to, or deletion from the rules of such self-regulatory organization . . . accompanied by a concise general statement of the basis and purpose of such proposed rule change. . . . No proposed rule change shall take effect unless approved by the Commission or otherwise permitted in accordance with the provisions of this subsection.").

53 15 U.S.C. §78s-(b)(2)(B) (2000) ("The Commission shall approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of this title and the rules and regulations thereunder applicable to such organization. The Commission shall disapprove a proposed rule change of a self-regulatory organization if it does not make such finding.").

54 *See supra* note 51; *see also* Self-Regulatory Organizations; Notice of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Improvements in the NASD Code of Arbitration Procedure, Exchange Act Release No. 34-30882, 51 S.E.C. Docket 1340 (July 1, 1992) ("[T]he Act requires the Association's rules to protect investors and the public interest.").

55 FLETCHER, *supra* note 23, at 3.

56 The NASDAQ is a publicly traded company that provides an electronic over-the-counter trading forum for approximately 3,200 companies. *See* NASDAQ, BUILT FOR BUSINESS: 2004 ANNUAL REPORT, *available at* http://www.nasdaq.com/about/AR2004/2004AR.pdf.

57 FLETCHER, *supra* note 23, at 3.

58 NASD—Arbitration & Mediation, NASD Dispute Resolution Fact Sheet, http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=884 (last visited Dec. 3, 2006).

59 *Id.*

computer-generated list of potential panelists, which contains extensive background information for each arbitrator, including past awards rendered.[60] Upon receipt of this list, parties may eliminate undesired arbitrators and rank remaining choices in order of preference.[61]

In 1992, there were 4,379 arbitration cases filed and 4,375 arbitration cases closed at the NASD.[62] By year end 2004, the number of arbitrations filed with the NASD had increased 87% to 8,201 and arbitrations closed increased 110% to 9,209.[63] The typical controversies involved in arbitration cases at the NASD include: margin calls, churning, unauthorized trading, failure to supervise, negligence, omission of facts, breach of contract, breach of fiduciary duty, unsuitability, and misrepresentation.[64] In 2004, 29% of cases were decided by arbitrators, 36% were directly settled by parties, 16% were settled by mediation, 9% were withdrawn, and the remainder were closed for various other reasons.[65]

II. THE PRO-ARBITRATION POLICY OF CONGRESS AND THE SUPREME COURT

A. *The Promulgation of the FAA*

Congress enacted the Federal Arbitration Act (FAA) in 1925,[66] which sought to expressly provide citizens with a procedural method of arbitration enforcement.[67] Prior to the adoption of the FAA, arbitration

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60 *Id.*

61 *Id.*

62 *See* NASD, Dispute Resolution Statistics: Summary Arbitration Statistics October 2006, http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=516&ssSourceNodeId=12 (last visited Dec. 3, 2006).

63 *Id.*

64 *Id.*

65 *Id.* Other reasons for closure include: stipulated award, bankruptcy of critical party, uncured deficient claim, forum denied, or stayed by court action.

66 9 U.S.C. §§ 1-14 (2000), first enacted February 12, 1925 (43 Stat. 883), codified July 30, 1947 (61 Stat. 669), and amended September 3, 1954 (68 Stat. 1233). Chapter 2 was added July 31, 1970 (84 Stat. 692), two new sections were passed by the Congress in October of 1988 and renumbered on December 1, 1990 (Pub. L. Nos. 669 and 702); Chapter 3 was added on August 15, 1990 (Pub. L. No. 101-369); and Section 10 was amended on November 15. The promulgation of the FAA made "valid and enforceable written provisions or agreements for arbitration of disputes arising out of contracts, maritime transactions, or commerce among the States or Territories with foreign Nations."

67 H.R. REP. NO. 68-96, at 1-2 (1924) ("The need for the law arises from an anachronism of our American law. Some centuries ago, because of the jealousy of the English courts for their own jurisdiction, they refused to enforce specific agreements to arbitrate upon the ground that the courts were thereby ousted from their jurisdiction. This jealousy survived for so long a period that the principle became firmly embedded in the English common law and was adopted with it by the American courts. The courts have felt that the precedent was too strongly fixed to be overturned without legislative enactment.").

agreements were revocable at the will of any party to the agreement and were generally not enforceable by the courts.[68] The Act unequivocally changed this practice, making arbitration agreements both enforceable and binding.[69] In drafting the FAA, Congress exhibited an "emphatically pro-arbitration" bias,[70] and intended to achieve three goals: (1) to make arbitration agreements as enforceable as any other contract, (2) to promote speedy resolution of commercial disputes, and (3) to ease the overbooked dockets of federal and state courts.[71]

B. *The Development of FAA Policy Through Seminal Supreme Court Decisions*

1. Judicial Reticence Toward Arbitration from 1953 to 1983

Although the concept of arbitration has endured through millennia,[72] judicial authorities opposed arbitration agreements for centuries prior to the adoption of the FAA.[73] This judicial hostility was conceived in English common law and later received in American courts.[74] The English courts, loathe to confer authority to arbitrators, invalidated arbitration agreements in order to retain coveted jurisdiction. This practice became entrenched in the English system of jurisprudence and persisted for many years in American courts.[75] As the case law developed over time, judicial hostility eased in the United States, especially after the promulgation of the FAA, and the courts ultimately developed an expansive initiative to rigorously enforce arbitration agreements.[76]

In 1953, the Supreme Court in *Wilko v. Swan*[77] voted seven to two against enforcing an arbitration agreement pursuant to a dispute arising

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68 Androski, *supra* note 10, at 634 ("Before congressional adoption of the FAA, contractual arbitration clauses were revocable at will. A party who had previously agreed to arbitration of disputes could opt unilaterally for litigation, severing the (now void) arbitration clause from the remainder of the agreement. Congress changed this option in 1924 with the adoption of the FAA.").

69 *See supra* note 66.

70 *See* UNIF. ARBITRATION ACT, prefatory note, 7 U.L.A. 1, 1-2 (Supp. 2001).

71 Androski, *supra* note 10.

72 *See supra* note 20.

73 *See supra* note 67.

74 *Id.*

75 *Id.*

76 *See generally infra* Part II.B.2; *see also* Scherk v. Alberto-Culver Co., 417 U.S. 506, 510-511 (1974) ("The United States Arbitration Act, now 9 U.S.C. § 1 et seq., reversing centuries of judicial hostility to arbitration agreements, was designed to allow parties to avoid 'the costliness and delays of litigation,' and to place arbitration agreements 'upon the same footing as other contracts . . . .'") (quoting H.R. REP. NO. 68-96, at 1-2 (1924)).

77 346 U.S. 427 (1953).

from an alleged violation of section 12(2) of the Securities Act. The Court explicitly refused to stay a court action pending arbitration as was required by the FAA.[78] Specifically, the Court held that enforcing the arbitration agreement would deprive the plaintiff of his choice of a judicial forum. The Court essentially saw compulsory arbitration as a diminution of the claimant's statutory rights under the Securities Act.[79] Contrary to its ruling, the Supreme Court in *Wilko* did, however, acknowledge the benefits of arbitration and recognized the legislative intent behind the FAA.[80] This decision exemplified the prevailing judicial reticence toward arbitration, which would endure for years to come.[81]

Over twenty years later, Justice Stewart wrote the majority opinion for the Supreme court in a five to four decision in *Scherk v. Alberto-Culver Co.*,[82] which softened the Court's antagonistic stance toward arbitration. In its decision, the Court carefully differentiated the facts from *Wilko* due to the international nature of the dispute and found the *Wilko* holding inapposite.[83] Free from *Wilko*, the *Scherk* court held the arbitration agreement enforceable under the FAA.[84] With the decision in *Scherk*, the Court began to view the arbitral process as legitimate and

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[78] 9 U.S.C. § 3 (2000). If any party to a Court action moves to compel arbitration subject to an arbitration agreement, Section 3 of the FAA requires a Court to stay the proceeding until the arbitration agreement has been satisfied according to its terms.

[79] *Wilko*, 346 U.S. at 435 ("When the security buyer, prior to any violation of the Securities Act, waives his right to sue in courts, he gives up more than would a participant in other business transactions. The security buyer has a wider choice of courts and venue. He thus surrenders one of the advantages the Act gives him and surrenders it at a time when he is less able to judge the weight of the handicap the Securities Act places upon his adversary.").

[80] *Id.* at 431-32; *see, e.g.*, *Scherk*, 417 U.S. at 511 ("In Wilko v. Swan . . . this Court acknowledged that the Act reflects a legislative recognition of the 'desirability of arbitration as an alternative to the complications of litigation,' . . . but nonetheless declined to apply the Act's provisions.").

[81] *See* Androski, s*upra* note 10, at 635.

[82] 417 U.S. at 508 n.1 (The disputed arbitration agreement stated in relevant part that "[t]he parties agree that if any controversy or claim shall arise out of this agreement or the breach thereof and either party shall request that the matter shall be settled by arbitration, the matter shall be settled exclusively by arbitration in accordance with the rules then obtaining of the International Chamber of Commerce, Paris, France, by a single arbitrator, if the parties shall agree upon one, or by one arbitrator appointed by each party and a third arbitrator appointed by the other arbitrators. . . . All arbitration proceedings shall be held in Paris, France, and each party agrees to comply in all respects with any award made in any such proceeding and to the entry of a judgment in any jurisdiction upon any award rendered in such proceeding. The laws of the State of Illinois, U.S.A. shall apply to and govern this agreement, its interpretation and performance.")

[83] *Id.* Alberto-Culver, a Delaware incorporated American manufacturer doing business in the U.S. and abroad, purchased a trademark from Scherk, an overseas company. The transaction was negotiated in several different European countries and ultimately closed in Geneva, Switzerland. The final contract contained an agreement to arbitrate disputes under the regulations of the International chamber of Commerce in Paris, France. When Alberto-Culver discovered that the trademarks were encumbered after purchase and worth less than promised, it filed suit in an American court and *Scherk* moved to dismiss for lack of jurisdiction.

[84] *Id.* at 519-20.

valuable,[85] and began to expand the scope of arbitrable issues.[86] Although this decision did not mark the death knell of *Wilko*, it certainly paved the way for reversal.

Following *Scherk*, in a six to three decision in 1983, the Supreme Court enforced another arbitration agreement in *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*,[87] this time with much stronger language. Justice Brennan, delivering the majority opinion, stated that the promulgation of the FAA exhibited a liberal legislative policy favoring arbitration *wherever it can be effectuated* without conflicting with substantive state or federal policies. The Court agreed with the well-settled appellate policy stating that questions of arbitration, including allegations of waiver and statutory construction, should be resolved in favor of arbitration as a matter of federal law.[88] Justice Brennan stated affirmatively that "as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration."[89] In the wake of *Moses*, key Supreme Court cases followed this emphatically pro-abritration holding and ultimately the previous quote became the cornerstone of modern interpretation of

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[85] Interestingly, the *Scherk* Court analogized the arbitral agreement in *Wilko* to a forum selection clause. *Id.* at 519. This analogy is critical to note, because it reflects the FAA's position that arbitration agreements are as enforceable as any other agreement. By analogizing arbitration agreements to another type of commonly encountered contractual provision, the Court was providing a quasi-instructional analysis of how future courts can interpret the textual requirements of the FAA. Therefore, if there is any doubt regarding enforceability of an arbitration agreement, lower courts can simply apply the same analysis to the arbitration agreement as they would a forum selection clause.

[86] The *Scherk* court expanded the scope of arbitration, but only in the international context. The Court was motivated by the desire to prevent a chilling of American participation in international commerce. If American courts retained jurisdiction over all international disputes and failed to honor international arbitration agreements under the FAA, then American business would suffer globally. *Id.* at 519-20 ("we hold that the agreement of the parties . . . to arbitrate any dispute arising out of their international commercial transaction is to be respected and enforced by the federal courts in accord with the explicit provisions of the Arbitration Act.").

[87] 460 U.S. 1 (1983).

[88] *Id.* at 24 ("The basic issue presented in Mercury's federal suit was the arbitrability of the dispute between Mercury and the Hospital. . . . Section 2 [of the FAA] is a congressional declaration of a liberal federal policy favoring arbitration agreements, notwithstanding any state substantive or procedural policies to the contrary. The effect of the section is to create a body of federal substantive law of arbitrability, applicable to any arbitration agreement within the coverage of the Act. . . . [T]he Courts of Appeals have [since 1967] consistently concluded that questions of arbitrability must be addressed with a healthy regard for the federal policy favoring arbitration. We agree. The Arbitration Act establishes that, as a matter of federal law, *any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration***,** whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability.") (emphasis added). Section 2 of the FAA is the primary substantive provision of the Act, declaring that a written agreement to arbitrate "in any maritime transaction or a contract evidencing a transaction involving commerce . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." *See* 9 U.S.C. § 2 (2000).

[89] *Moses*, 460 U.S. at 24.

arbitral availability under the FAA.[90] Today, courts continue to follow *Moses* and require the application of arbitration wherever there is legal discretion to do so.[91]

2. The Supreme Court's Embrace of Arbitration from 1985 to 1989: The Demise of *Wilko*

From 1985 to 1989, a series of four seminal Supreme Court decisions conclusively ended the judicial apprehension toward arbitration and expressly overruled *Wilko* in 1989.[92]

The first case in the series, *Dean Witter Reynolds v. Byrd*,[93] was decided in 1985 by a unanimous vote in favor of arbitration. In this case, the plaintiff alleged violations of the Exchange Act.[94] Since the *Wilko* dispute concerned the Securities Act, the *Dean Witter* court differentiated the facts and held *Wilko* inapposite.[95] The Supreme Court unanimously held that the FAA does extend to disputes arising from violations of the Exchange Act and that agreements to arbitrate such claims are enforceable. The court emphasized that the congressional directive to resolve disputes in favor of arbitration requires the "courts to enforce the bargain of the parties to arbitrate, and 'not substitute [its] own views of economy and efficiency' for those of Congress."[96] Thus, even where an arbitration agreement may not be the most efficient method of resolving the dispute, the courts are compelled to enforce the agreement nonetheless.[97]

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[90] The following United States Supreme Court cases discussing enforcement of arbitration agreements all cite this specific phrase in *Moses*: First Options of Chi., Inc. v. Kaplan, 514 U.S. 938, 945 (1995); Dean Witter Reynolds Inc. v. Byrd, 470 U.S. 213, 221 (1985); Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 626 (1985); *see also* AT&T Techs., Inc., v. Commc'ns Workers of Am., 475 U.S. 643, 650 (1986) ("[T]here is a presumption of arbitrability . . . . Doubts should be resolved in favor of coverage."); Green Tree Fin. Corp. v. Bazzle, 539 U.S. 444, 452 (2003) ("if there is doubt about that matter—about the 'scope of arbitrable issues'—we should resolve that doubt 'in favor of arbitration.'").

[91] *See infra* Part III.B.2.

[92] In chronological order from 1985 to 1989: *Dean Witter*, 470 U.S. 213 (1985); *Mitsubishi Motors*, 473 U.S. 614 (1985); Shearson/Am. Express Inc. v. McMahon, 482 U.S. 220 (1987); Rodriguez De Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477 (1989).

[93] 470 U.S. 213 (1985).

[94] *Id.*

[95] *Id.* at 216 ("this Court questioned the applicability of *Wilko* to a claim arising under § 10(b) of the Securities Exchange Act of 1934, or under Rule 10b-5, because the provisions of the 1933 and 1934 Acts differ . . . . Dean Witter . . . representing the securities industry urge[s] us to resolve the applicability of *Wilko* to claims under § 10(b) and Rule 10b-5. We decline to do so. In the District Court, Dean Witter did not seek to compel arbitration of the federal securities claims. Thus, the question whether *Wilko* applies to § 10(b) and Rule 10b-5 claims is not properly before us.).

[96] *Id.* at 217 (citation omitted) (modification in original).

[97] *Id.*

Following *Dean Witter*, the Supreme Court's decisions in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*[98] in 1985 and *Shearson/American Express Inc. v. McMahon*[99] in 1987 established a liberal interpretive policy with respect to the FAA and evidenced a drastic change in the judicial view of arbitration since *Wilko*. Once suspicious of the arbitral process, the Supreme Court, by 1985, fully embraced arbitration and substantially expanded the enforcement of such agreements.[100] In *Mitsubishi*, the Court extended the scope of arbitration to include statutory claims in an international context, in this case the Sherman Act.[101] The Court held that the party invoking his statutory protection does not lose any of his substantive rights by arbitrating, but simply "trades the procedures and opportunity for review of the courtroom for the simplicity, informality, and expedition of arbitration."[102] Two years later, in *McMahon*, the Court extended the *Mitsubishi* holding to the domestic context and found RICO and Exchange Act claims arbitrable. The Court found that, where the FAA is silent, an agreement to arbitrate is presumptively valid and the challenging party must affirmatively demonstrate that Congress intended an arbitration exception for these specific causes of action.[103] The *McMahon* court found no such intention, despite the fact that several circuits had held RICO claims non-arbitrable.[104] Moreover, the Court expressly indicated its favor of the arbitral process and opined that arbitration of RICO claims would "advance society's fight against organized crime."[105] Despite the obvious conflict between *McMahon* and *Wilko*, the Supreme Court failed to expressly overturn *Wilko* in

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98 473 U.S. 614 (1985).

99 482 U.S. 220 (1987).

100 *Id.* at 226. Two years after *McMahon*, the Supreme Court addressed *Wilko*'s hostility, stating that "we are well past the time when judicial suspicion of the desirability of arbitration and of the competence of arbitral tribunals inhibited the development of arbitration as an alternative means of dispute resolution." *Mitsubishi*, 473 U.S. at 626-27.

101 *Id.* at 628 ("By agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum.").

102 *Id.*

103 *McMahon*, 482 U.S. at 226-27 ("Like any statutory directive, the Arbitration Act's mandate may be overridden by a contrary congressional command. The burden is on the party opposing arbitration, however, to show that Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue.").

104 *Id.* at 225 n.1.

105 *Id.* at 241-42 ("Not only does *Mitsubishi* support the arbitrability of RICO claims, but there is even more reason to suppose that arbitration will adequately serve the purposes of RICO than that it will adequately protect private enforcement of antitrust laws. . . . RICO's drafters . . . sought to provide vigorous incentives for plaintiffs to pursue RICO claims that would advance society's fight against organized crime. . . . But in fact RICO actions are seldom asserted against the archetypical, intimidating mobster. The special incentives necessary to encourage civil enforcement actions against organized crime do not support nonarbitrability of . . . civil RICO claims brought against legitimate enterprises.").

McMahon.

Finally, in 1989, the Supreme Court in *Rodriguez de Quijas v. Shearson/American Express, Inc.*[106] expressly overturned *Wilko*.[107] Justice Stevens, writing for the majority, affirmatively extolled arbitration and conclusively renounced the *Wilko* sentiment, stating that "[t]o the extent that *Wilko* rested on suspicion of arbitration as a method of weakening the protections afforded in the substantive law to would-be complainants, it has fallen far out of step with our current *strong endorsement of the federal statutes favoring this method of resolving disputes*."[108] Under *Rodriguez*, the Court set forth the standard that the party who opposes enforcement of an arbitration agreement bears the burden of proving that either Congress specifically intended in another statute that the FAA shall not apply to this cause of action or that a waiver of arbitration is necessary to prevent a conflict with the purpose of another statute.[109] Thus, under *Rodriguez*, arbitration agreements are presumptively valid.

III. CLASS ACTION ARBITRATION

A. *What Is a Class Action and Why Is It Necessary?*

A class action is simply a "lawsuit in which a single person or a small group of people represents the interests of a larger group."[110] The primary purpose of the class action is to provide a procedural mechanism for recovery to a large group of claimants who seek individual damages that are too small to practicably pursue in an individual capacity. The class action device creates economies of scale by aggregating the claims of numerous individuals, thereby creating a singular pool of damages large enough to attract qualified attorneys who would be otherwise disinterested.[111]

Rule 23 of the Federal Rules of Civil Procedure (FRCP) sets forth

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106 490 U.S. 477 (1989).

107 *Id.* at 480-81.

108 *Id.* at 481 (emphasis added).

109 *Id.* at 483 ("Under [the FAA], the party opposing arbitration carries the burden of showing that Congress intended in a separate statute to preclude a waiver of judicial remedies, or that such a waiver of judicial remedies inherently conflicts with the underlying purposes of that other statute.").

110 BLACK'S LAW DICTIONARY 103 (2d pocket ed. 2001).

111 Amchem Prods., Inc. v. Windsor, 521 U.S. 591, 617 (1997) ("The policy at the very core of the class action mechanism is to overcome the problem that small recoveries do not provide the incentive for any individual to bring a solo action prosecuting his or her rights. A class action solves this problem by aggregating the relatively paltry potential recoveries into something worth someone's (usually an attorney's) labor.") (quoting Mace v. Van Ru Credit Corp., 109 F.3d 338, 344 (7th Cir. 1997)).

the procedural rules and requirements for class actions to proceed in federal court.[112] Under FRCP 23(a), there are four initial prerequisites to form a class. First, the class must be so numerous that simple joinder is impracticable. Second, there must be commonality such that the same question of law or fact is involved. Third, the claims or defenses of the named parties must be typical to the rest of the class. Finally, the representatives of the named parties must adequately and fairly protect the interests of all parties, including those parties who are not yet known at the time the class is certified.[113] In addition to the requirements set forth by FRCP 23, constitutional due process also requires that adequate notice must be provided to all identifiable members of a class[114] and courts must also consider whether the class action is manageable, i.e. appropriate given the circumstances in the case.[115]

B. *The Jurisprudential Split Regarding the Permissibility of Class Action Arbitration Where the Agreement Is Silent*

Although class actions are a valuable and necessary procedural device, the FAA does not expressly address whether arbitration is available for class action claims.[116] Consequently, lower courts failed to uniformly interpret this issue until the Supreme Court decided the issue in *Green Tree Financial Corp. v. Bazzle*[117] in 2003.

To further complicate the matter, parties have historically failed to provide any express language in their predispute arbitration agreements with respect to class arbitration.[118] Section 4 of the FAA requires the courts to enforce arbitration agreements according to their terms,[119] and the Supreme Court has declared that arbitration terms are presumptively

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112 FED. R. CIV. P. 23.

113 *Id.*

114 *See, e.g.*, Eisen v. Carlisle & Jacquelin, 417 U.S. 156, 165 (1974) ("[B]oth the Rule and the Due Process Clause of the Fifth Amendment required individual notice to all class members who could be identified.").

115 FED. R. CIV. P. 23(b)(3)(D).

116 *See* 9 U.S.C. §§ 1-14 (2000). At the time the FAA was promulgated in 1925, class action litigation for damages was virtually nonexistent in federal jurisdictions. *See* Discover Bank v. Superior Court of Los Angeles, 113 P.3d 1100, 1110 (Cal. 2005).

117 539 U.S. 444 (2003).

118 *See* Samuel Estreicher & Kenneth J. Turnbull, *Class Actions and Arbitration*, N.Y.L.J., May 4, 2000, at 3, *available at* http://www.omm.com/communication/2000/june5/class_actions.-html.

119 9 U.S.C. § 4 (2000) ("A party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition any United States district court . . . for an order directing that such arbitration proceed in the manner provided for in such agreement. . . . The court shall hear the parties, and upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration *in accordance with the terms of the agreement*.") (emphasis added).

valid.[120] Where the terms are not expressly stated in a predispute agreement, the relevant issue becomes what *kind* of arbitration proceeding did the parties agree to?[121] The failure of parties to address class action arbitration in their predispute arbitration agreement ultimately led to a split among courts at both the state and federal levels. Some courts interpreted the silence narrowly, limiting the scope of arbitration to expressly agreed upon terms and precluding arbitration of class actions.[122] Other courts have interpreted the silence expansively and held, consistent with *Moses*,[123] that the scope of the agreement should be read to favor arbitration of class action claims.[124]

In 2003, the *Bazzle* court effectively reconciled the split by concluding that (1) class arbitration *is* permissible under the FAA, even where the agreements are silent, and (2) arbitrators, not judges, should interpret the predispute arbitration agreements to consider whether arbitration of class claims is available.[125] Following *Bazzle*, class action arbitration has become a common mechanism of dispute resolution.[126]

C. *Prohibiting Classwide Arbitration: The* Champ *Court, et al.*

In 1989, the Eleventh Circuit held in *Protective Life Insurance Corp. v. Lincoln National Life Insurance Corp.*[127] that arbitrations could

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120 *See generally supra* Part II.B.

121 *Bazzle*, 539 U.S. at 452.

122 *See, e.g.*, Champ v. Siegel Trading Co., Inc., 55 F.3d 269, 275 (7th Cir. 1995); Gammaro v. Thorp Consumer Disc. Co., 828 F. Supp. 673, 674 (D. Minn. 1993).

123 460 U.S. 1 (1983); *see generally supra* Part II.B.

124 *See, e.g.*, Keating v. Super Cout of Alameda County, 167 Cal. Rptr. 481 (Ct. App. 1980); Dickler v. Shearson Lehman Hutton, Inc., 596 A.2d 860 (Pa. Super. Ct. 1991).

125 539 U.S. 444 (2003).

126 In response to *Bazzle*, arbitration agreements in consumer adhesion contracts increasingly contain express waivers of the right to arbitrate class actions. Many courts have held these waivers unconscionable and unenforceable under state law, despite the FAA requirement in section 4 to enforce an arbitration agreement according to its terms. In voiding the class action arbitration waiver, some courts will certify the class for arbitration while other courts will certify the class for a court proceeding. In *Discover Bank v. Superior Court of Los Angeles*, 113 P.3d 1100, 1110 (Cal. 2005), for example, the California Supreme Court held that the FAA does not prohibit a California court from refusing to enforce a class action waiver. The Court stated,

> "California law, like federal law, favors enforcement of valid arbitration agreements. . . . Thus, under both federal and California law, arbitration agreements are valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." . . . In other words, although under federal and California law, arbitration agreements are enforced "in accordance with their terms" . . . such enforcement is limited by certain general contract principles "at law or in equity for the revocation of any contract."

Id.; *see also* Ting v. AT&T, 319 F.3d 1126 (9th Cir. 2003); Kinkel v. Cingular Wireless, LLC, 828 N.E.2d 812 (Ill. App. 2005); Eagle v. Fred Martin Motor Co., 809 N.E.2d 1161 (Ohio App. 2004).

127 873 F.2d 281 (11th Cir. 1989).

not be consolidated unless the agreement expressly makes consolidation available.[128] The court's rationale was that the FAA requires arbitration agreements to be enforced by their terms and that parties may negotiate for and include provisions for consolidation, "but if such provisions are absent," as is typically the case, "federal courts may not read them in."[129] Following *Protective Life*, the District of Minnesota ruled in 1993 that class action arbitration of Truth in Lending Act claims was unavailable to parties where the contract is silent.[130] Neither the Eleventh Circuit, nor the District of Minnesota, in precluding class arbitration, established any preference for or against the practice. Both courts merely attempted to interpret the contract, as the FAA requires, by its own terms.[131]

From 1995 to 2003, *Champ v. Siegel Trading Co., Inc.*,[132] decided by the Seventh Circuit, was the leading case precluding class arbitration where the predispute agreement was silent.[133] Again, the Seventh Circuit held that the FAA requires the courts to enforce an arbitration agreement by its own terms and *Champ* interpreted silence in a contract as having a preclusive effect. The Seventh Circuit found that absent an agreement to arbitrate class claims, neither the FAA nor the rules of the American Arbitration Association (AAA) independently provide courts with authority to order arbitration panels to hear claims on a classwide basis.[134]

This narrow interpretation of the FAA suggests that enforcement of arbitration agreements is limited to expressly agreed upon terms. *Champ* conceded, however, that class action arbitration *might* be allowed under the FAA if the parties expressly provided for it, but that silence affirmatively limits its availability.[135] The *Champ* court

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128 *Id.*

129 *Id.* at 282.

130 The Minnesota court analogized class arbitration to consolidation for the purpose of interpreting the predispute agreement and cited *Protective Life* as an authority for its decision. *See* Gammaro v. Thorp Consumer Disc. Co., 828 F. Supp. 673, 674 (D. Minn. 1993) ("Certainly consolidation is not identical to class treatment, but in this Court's view . . . a similar result [is compelled] when class treatment is sought. The Court must give effect to the agreement of the parties, and this arbitration agreement makes no provision for class treatment of disputes. Accordingly, the Court finds that it is without power to order this matter to proceed to arbitration as a class action.").

131 9 U.S.C. § 4 (2000).

132 55 F.3d 269 (7th Cir. 1995).

133 *Id.*; *see also* Jean R. Sternlight, *As Mandatory Binding Arbitration Meets the Class Action, Will the Class Action Survive?*, 42 WM. & MARY L. REV. 1, 70 (2000).

134 *Champ*, 55 F.3d at 276.

135 The FAA requires that an arbitration agreement shall be enforced by its terms. *See supra* note 78. Because the *Champ* court enforced the arbitration agreement by its *express* terms, the holding was not technically in conflict with the FAA. However, in interpreting a contract, courts are directed to use their discretion concerning the scope of arbitrable issues in favor of arbitration. Since silence in a contract provides ample judicial discretion, and the type of arbitrable forum is an issue of arbitration, *Champ*'s limitation of class action arbitration is therefore offensive to the

reasoned that because the parties could have conceivably included such terms, an omission manifests a contrary intent.[136]

D. *Allowing Classwide Arbitration: The* Keating *Court*

In 1980, the California Appellate Court in *Keating v. Superior Court of Alameda County*[137] became the first court in the nation to expressly allow arbitration on a classwide basis.[138] The terms of the agreement disputed in *Keating* did not expressly provide for class action arbitration, but did state that "any controversy or claim" was subject to mandatory arbitration.[139] The plaintiffs argued that if arbitration is compulsory, then it should proceed on a class action basis, not an individual one.

The *Keating* court acknowledged that while no direct federal authority existed in 1980 to allow for classwide arbitration, the same theory that supports consolidation of claims for arbitration would logically extend to class action arbitration.[140] By this analogy, the

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United States Supreme Court's directive in *Moses*. Because of *Champ*'s narrow application of the FAA, subsequent case law limited the applicability of the *Champ* doctrine. *See, e.g.*, Conn. Gen. Life Ins. Co. v. Sun Life Assurance Co. of Canada, 210 F.3d 771, 773 (7th Cir. 2000).

136 *Champ*, 55 F.3d at 276. Under this standard, parties would be forced to expressly provide for every minute detail of their arbitration agreement, or would be deemed to have waived their rights.

137 167 Cal. Rptr. 481, 492 (Ct. App. 1980) ("We have concluded that there is no insurmountable obstacle to conducting an arbitration on a classwide basis. In an appropriate case, such a procedure undoubtedly would be the fairest and most efficient way of resolving the parties' dispute. The initial determinations regarding certification and notice will not unduly burden the arbitration because those matters must be resolved by the trial court before arbitration begins."). The dispute in *Keating* arose between Southland Corporation, owner and franchisor of 7-Eleven convenience store operations, and several of its franchisees, who individually alleged claims including fraud, oral misrepresentation, breach of contract, breach of fiduciary duty, and violations of franchise laws. *Keating*, representing approximately 800 similarly situated franchisees in California, then filed a class action against Southland.

138 *See* Dickler v. Shearson Lehman Hutton, Inc., 596 A.2d 860, 864 (Pa. Super. Ct. 1991) ("We agree with the California appellate court [in *Keating*] which was the first to allow class actions in arbitration proceedings . . . .").

139 *See* Keating v. Superior Court of Alameda County, 645 P.2d 1192, 1195 (Cal. 1982). The agreement states that "[a]ny controversy or claim arising out of or relating to this Agreement or the breach thereof shall be settled by arbitration in accordance with the Rules of the American Arbitration Association . . . and judgment upon any award rendered by the arbitrator may be entered in any court having jurisdiction thereof." *Id.* If *Keating* were decided today, then under the terms of the same agreement, the dispute would be subject to compulsory class action arbitration by the AAA. The Rules of the AAA currently require that a class action is arbitrable, unless explicitly precluded in an agreement. *See infra* note 152. Therefore, an agreement to arbitrate "any and all disputes" is deemed to conclusively include any class actions, except where expressly prohibited.

140 *Keating*, 167 Cal. Rptr. at 490 ("Applying rule 23 of the Federal Rules of Civil Procedure to arbitration proceedings would appear to be a logical extension of the theory employed in the consolidation cases."). The consolidation-class action analogy made by the California Appellate Court would continue to be employed by future courts. *See, e.g.*, Gammaro v. Thorp Consumer

Keating court held that class action arbitration is permissible, and further, is actually preferable to litigation in appropriate cases.[141]

On appeal, the Supreme Court of California failed to find any direct authority in the FAA with respect to class action arbitration,[142] but agreed with the appellate court's logic that analogous authority concerning consolidation would support classwide arbitration as a matter of law.[143] California's highest court acknowledged certain obstacles inherent in classwide arbitration proceedings and declared that, while it is available under the FAA, classwide arbitration would require enhanced judicial involvement.[144] The California court's decision was appealed to the United States Supreme Court, which declined to rule on the availability of class action arbitration under the FAA.[145]

E. Bazzle *Reconciles the Split*

Prior to *Bazzle*,[146] defense attorneys would typically compel

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Disc. Co., 828 F. Supp. 673 (D. Minn. 1993).

141 *Keating*, 167 Cal. Rptr. at 492.

142 *Keating*, 31 Cal.3d at 610 ("There is . . . an absence of direct authority either supporting or rejecting [classwide arbitration].").

143 *Id.* at 610-11. The Federal Rules of Civil Procedure (FRCP) Rule 81(a) (provided in pertinent part below) states that the federal rules shall be a procedural "gap filler" for purposes of certain statutes, including the FAA. Since the FAA does not address consolidation and consolidation is considered a procedural issue, then, under FRCP 81(a) courts have deemed FRCP 42(a), which permits consolidation of related proceedings, applicable to the FAA. The *Keating* court analogized class action rule FRCP 23 to the consolidation rule FRCP 42(a) and held that class actions are also applicable to the FAA, since the FAA fails to provide guidance for these procedures as well. Gap filler rule FRCP 81(a) states in pertinent part:

> In proceedings under Title 9, U.S.C., relating to arbitration . . . these rules apply only to the extent that matters of procedure are not provided for in those statutes. These rules apply to proceedings to compel the giving of testimony or production of documents in accordance with a subpoena issued by an officer or agency of the United States under any statute of the United States except as otherwise provided by statute or by rules of the district court or by order of the court in the proceedings.

FED. R. CIV. P. 81(a).

144 *Keating*, 31 Cal.3d at 613.

145 Southland Corp. v. Keating, 465 U.S. 1, 10-11 (1984). The Supreme Court declined to rule whether class action arbitration is available under the FAA, but declared that a plain language reading of the FAA reveals only two limitations regarding its applicability.

> We discern only two limitations on the enforceability of arbitration provisions governed by the Federal Arbitration Act: they must be part of a written maritime contract or a contract "evidencing a transaction involving commerce" and such clauses may be revoked upon "grounds as exist at law or in equity for the revocation of any contract." We see nothing in the Act indicating that the broad principle of enforceability is subject to any additional limitations under State law.

Id. The Supreme Court declared that the only limitations to FAA applicability are the express, plain language limitations in the Act. It refused to provide for the availability of any additional, implied limitations to the FAA.

146 539 U.S. 444 (2003).

arbitration against class claimants on an individual basis and force automatic decertification of the class.[147] *Bazzle* effectively ended this practice[148] and held in a plurality ruling[149] that whether a contract is silent or forbids class action arbitration is a question for the arbitrator to decide.[150] Under this holding, the arbitrator, and not the courts, has the right to determine whether a class action should proceed via arbitration or litigation.[151] In the wake of this decision, the AAA changed its policy to allow for the arbitration of all claims, unless the parties explicitly contracted to prohibit such actions in their predispute agreements.[152] Currently, the AAA has almost 100 class actions on its

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147 Dawson, *supra* note 41, at 1, ("Prior to the United States Supreme Court's decision in *Green Tree Financial Corp v. Bazzle* . . . arbitration clauses in consumer contracts were routinely utilized by defense counsel in order to defeat class certification. Where the contract permitted the corporation to demand arbitration unilaterally . . . a corporate defendant's first response to the filing of a putative class action was to prepare a letter to plaintiff's counsel invoking its right to demand arbitration."); *see also supra* note 126.

148 Dawson, *supra* note 41, at 1 ("Post-*Green Tree* . . . in response to defense counsel's motion to dismiss and demand for arbitration, plaintiff's counsel would simply demand a class-wide arbitration and make their case for class treatment before an arbitrator.").

149 Four Justices held that the question of whether a contract is silent with respect to class action arbitration is for the arbitrator to decide. Green Tree Fin. Corp. v. Bazzle, 539 U.S. 444, 452 (2003). Justice Stevens filed an individual concurring opinion stating that the availability of class action arbitration is a matter of state law and if it is not prohibited by the predispute agreement, then the arbitrator should decide whether to compel classwide arbitration. *Id.* at 454-55 (Stevens, J., concurring in the judgment and dissenting in part). Justices Rehnquist, Kennedy, and O'Connor dissented, stating that whether a predispute agreement is silent with respect to classwide arbitration is for the court, not the arbitrator to decide. *Id.* at 455-56 (Rehnquist, C.J., dissenting). Chief Justice Rehnquist stated further that a plain language reading of this particular agreement in dispute includes the terms "us" (the petitioner) and "you" (the respondent). Under FAA section 4, the agreement must be enforced by its terms. Accordingly, Chief Justice Rehnquist stated that the terms used in the agreement expressly require resolution of the dispute on a two party basis, i.e. us (petitioner) versus you (individual respondent). *Id.* at 455-59. Justice Thomas dissented individually, stating simply that the FAA does not apply to state court proceedings. *Id.* at 460 (Thomas, J., dissenting).

150 *Id.* at 452.

151 *Id.*

152 American Arbitration Association, American Arbitration Association Policy on Class Arbitrations, http://www.adr.org/Classarbitrationpolicy (last updated July 14, 2005) (last visited Dec. 4, 2006) ("On October 8, 2003, in response to the ruling of the United States Supreme Court in *Green Tree Financial Corp. v. Bazzle*, the American Arbitration Association issued its Supplementary Rules for Class Arbitrations to govern proceedings brought as class arbitrations. In *Bazzle*, the Court held that, where an arbitration agreement was silent regarding the availability of classwide relief, an arbitrator, and not a court, must decide whether class relief is permitted. Accordingly, the American Arbitration Association will administer demands for class arbitration pursuant to its Supplementary Rules for Class Arbitrations if (1) the underlying agreement specifies that disputes arising out of the parties' agreement shall be resolved by arbitration in accordance with any of the Association's rules, and (2) the agreement is silent with respect to class claims, consolidation or joinder of claims. The Association is not currently accepting for administration demands for class arbitration where the underlying agreement prohibits class claims, consolidation or joinder, unless an order of a court directs the parties to the underlying dispute to submit any aspect of their dispute involving class claims, consolidation, joinder or the enforceability of such provisions, to an arbitrator or to the Association.").

class arbitration case docket.[153]

Although the *Bazzle* holding failed to produce a majority opinion regarding *who* should determine if class action arbitration is available, it is of paramount significance that the Justices determined that class action arbitration simply *is* available under the FAA.[154] At the time of the *Bazzle* decision, there were arguments that classwide arbitration is contrary to the purpose of the FAA. This proposition holds that arbitration of a class dispute would be far less efficient and cumbersome than arbitration of individual disputes.[155] The *Bazzle* court easily could have dispensed with classwide arbitration, declaring it inconsistent with the FAA and unavailable as a matter of law. However, the plurality of the court held that state law rules should determine whether class arbitration is authorized, which implies that classwide arbitration is consistent with the FAA.[156]

IV. THE NASD EXCLUSIONARY RULE

A. *The Adoption of the Exclusionary Rule*

Prior to the Exclusionary Rule, defense counsel would compel individual arbitration against class claimants and force automatic decertification of the class.[157] A claimant would thus have no forum to bring their class claims and would instead be subjected to individual arbitration, often against defendants with vastly superior resources.[158] Likewise, the NASD would be relegated to resolve duplicative

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153 American Arbitration Association, Class Action Cases, http://www.adr.org/sp.asp?*id*=25562 (last visited Dec. 4, 2006).

154 Even Chief Justice Rehnquist, who would have narrowly construed the disputed agreement in this instance and held that it prohibits class action arbitration, agrees that class action arbitration is available under the FAA if the parties provide for it. *Bazzle*, 539 U.S. at 459 (Rehnquist, C.J., dissenting) ("As petitioner correctly concedes . . . *the FAA does not prohibit parties from choosing to proceed on a classwide basis*.") (emphasis added).

155 *See, e.g.*, Discover Bank v. Superior Court of Los Angeles, 113 P.3d 1100, 1116 (Cal. 2005) ("Amicus curiae United States Chamber of Commerce argues that the imposition of classwide arbitration undermines the purpose of the FAA by drastically altering the rules by which the parties agreed to arbitrate, transforming arbitration into a less efficient and less desirable mechanism of dispute resolution.").

156 *Id.* at 172.

157 S*ee supra* note 147; *see also* Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change Relating to the Exclusion of Class Actions From Arbitration Proceedings, Exchange Act Release No. 34-31371, 57 Fed. Reg. 52659, 52661 (Nov. 4, 1992) ("In the past, individuals who attempted to certify class actions in litigation were subject to the enforcement of their separate arbitration contracts by their broker-dealers. Without access of class actions . . . both investors and broker-dealers have been put to the expense of wasteful, duplicative litigation.").

158 *See supra* notes 41-43 and accompanying text.

arbitration of substantially similar issues of fact and law.[159]

In 1988, David S. Ruder, chairman of the SEC at the time, recognized this failing and proposed that the SROs consider adopting procedures that would give investors exclusive access to class actions in the courts (Ruder Request).[160] The NASD's National Arbitration Committee initially rejected the proposal, favoring the broad discretion that the NASD Code provides the arbitrators.[161] Only after the Securities Industry Conference on Arbitration (SICA) modified the Uniform Code of Arbitration (UCA)[162] in consideration of the Ruder Request[163] and urged the SROs to address the class action issue,[164] did the NASD finally modify its rules.[165] Accordingly, the NASD adopted the Exclusionary Rule, which provides that members of a class action cannot be compelled to arbitrate claims encompassed by the class action.[166] Further, the Exclusionary Rule states that the exclusive forum

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159 *Id.*

160 Self-Regulatory Organizations; Notice of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Improvements in the NASD Code of Arbitration Procedure, Exchange Act Release No. 34-30882, 51 SEC-Docket 1340 (July 1, 1992) ("This proposed rule change developed from a suggestion made to all self-regulatory organizations (SROs) in a letter dated July 13, 1988, form the Chairman of the Securities and Exchange Commission, David S. Ruder. Chariman Ruder asked the SROs to consider adopting procedures that would give investors access to the courts in appropriate cases, including class actions."); *see also* JEAN I. FEENEY, FAIR LABOR STANDARDS ACT CLASS ACTIONS ARE INELIGIBLE FOR ARBITRATION IN THE NASD REGULATION FORUM (1999).

161 Self-Regulatory Organizations; Notice of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Improvements in the NASD Code of Arbitration Procedure, Exchange Act Release No. 34-30882, 51 SEC-Docket 1340 (July 1, 1992) (stating, "The NASD's National Arbitration Committee, after considering Ruder's request, decided not to propose a rule change at that time in light of the broad discretion that the Code gives the arbitrators and the Director of Arbitration to defer certain arbitration proceedings to the remedies provided by applicable law.").

162 SICA promulgated and continues to develop the UCA. This code is a model that various organizations and legislative bodies use to promulgate their arbitral policy. The NASD currently conducts arbitrations in accordance with both the UCA, which is developed and maintained by SICA, and the rules of the sponsoring organization where the claim is filed. *See* NASD-Arbitration & Mediation, http://www.nasd.com/ArbitrationMediation/index.htm (last visited Jan. 20, 2006); *see also supra* note 49.

163 *See supra* note 161.

164 *Id.* After the NASD initially rejected Ruder's proposal, "SICA determined separately, however, that it would be preferable for each SRO to clarify in its rules the treatement of class actions and, since 1990, SICA has been devoping such rules for the Uniform Code."

165 Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change Relating to the Exclusion of Class Actions From Arbitration Proceedings, Exchange Act Release No. 34-31371, 57 Fed. Reg. 52659 (Nov. 4, 1992) ("On January 7, 1992, SICA unanimously adopted a final version of these [class action] rules. The SICA language has been modified to conform to the NASD's Code provisions . . . with minor technical changes . . . .").

166 *See* SEC Approval of Amendments Concerning the Exclusion of Class-Action Matters From Arbitration Proceedings and Requiring that Predispute Arbitration Agreements Include a Notice that Class-Action Matters May Not Be Arbitrated, NASD Notice to Members 92-65 (1992), *available at* http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159004127.

for a class action claim shall be in the courts.[167] With the promulgation of this class action exclusion, the NASD foreclosed the possibility that defense counsel could deprive claimants of the class action device,[168] yet simultaneously deprived claimants of access to arbitration for class action claims.[169]

Ostensibly, the reason why the NASD chose litigation rather than arbitration for the resolution of class action claims was due to the Ruder Request sentiment that arbitration would be "difficult, duplicative and wasteful."[170] Another likely reason why the NASD may have agreed that class actions were "better handled" by the judicial system than arbitration is that[171] at the time the NASD promulgated this rule, it was unclear whether arbitration of class claims was even permitted under the FAA.[172] The Supreme Court did not answer this until 2003, over a full decade after the promulgation of the Exclusionary Rule.[173]

In addition to the lack of instructive classwide arbitration jurisprudence, there were also concerns regarding arbitration procedures and questions of fairness to claimants at the time the NASD promulgated the Exclusionary Rule.[174] In 1992, the United States General Accounting Office (GAO) performed a study of the securities arbitration system to address these fairness concerns and found *no bias* in favor of securities industry members.[175] In spite of this finding, Former SEC chair David S. Ruder, critical of the state of securities arbitration in the early nineties, chaired an Arbitration Policy Task Force appointed by the NASD and conducted an independent investigation.[176] Based on the Ruder Report's findings and recommendations, the SROs took substantive actions to improve the

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167 *Id.*

168 *See* STERNLIGHT, *supra* note 133, at 45-46 ("In adopting the exclusion, both the SROs and the SEC foreclosed the possibility that companies might be permitted to deprive customers of the class action device simultaneously in both litigation and arbitration forums.").

169 *Id.*

170 In the NASD announcement of the Rule and in NASD responses to comment letters concerning the Rule, the NASD refers to the Ruder Request as the rationale for the Rule. *See* Order Approving Proposed Rule Change Relating to the Exclusion of Class Actions, 57 Fed. Reg. at 52661; FEENEY, *supra* note 160.

171 Order Approving Proposed Rule Change Relating to the Exclusion of Class Actions, 57 Fed. Reg. at 52660.

172 *See supra* Part III.B.

173 Green Tree Fin. Corp. v. Bazzle, 539 U.S. 444 (2003).

174 MICHAEL A. PERINO, IS SECURITIES ARBITRATION FAIR FOR INVESTORS? 6 (Mar. 17, 2005), http://financialservices.house.gov/media/pdf/031705mp.pdf (written testimony before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services, United States House of Representatives).

175 U.S. GEN. ACCOUNTING OFFICE, SECURITIES ARBITRATION: HOW INVESTORS FARE 6 (1992).

176 REPORT OF THE ARBITRATION POLICY TASK FORCE TO THE BOARD OF GOVERNORS NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC. (Jan 1996), *reprinted in* [1995-1996 Tr. Binder] Fed. Sec. L. Rep. (CCH).

fairness in the arbitration system.[177]

Since the promulgation of the Exclusionary Rule over a decade ago, many of the criticisms of securities arbitration and the question concerning class action arbitrability have been resolved. The NASD, however, has not changed its position with respect to class action arbitration and continues to maintain its strict prohibition.[178]

B. *The NASD Should Repeal the Exclusionary Rule*

1. The Exclusionary Rule Conflicts with the Pro-Arbitration Policy of the FAA

The NASD prohibition of class action arbitration conflicts with the policy of the FAA.[179] The clearest example of inconsistency between the FAA and the Exclusionary Rule is found by a plain language reading of the congressional objective in promulgating the FAA.

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177 *See* PERINO, *supra* note 174, at 10-11. The Ruder Report, for example, concluded that the SRO conflict disclosure requirements for arbitrators could be enhanced to promote better transparency. The NASD went beyond the recommendations made by Ruder and aimed high to protect the integrity of NASD arbitration and enhance public confidence.

178 In policy developments promulgated after the initial prohibition of class action arbitration in 1992, the NASD has reinforced its class action arbitration exclusion. In 1998, for example, the NASD adopted new disclosure requirements for customer account opening documents, which reinforced the narrow exception to the arbitrability of class actions. According to the 1998 changes, if a member compels arbitration against a customer with respect to any claim the customer makes, the customer has the right to compel arbitration for *all* of its claims against the member. However, consistent with the 1992 prohibition, the NASD carved out a specific exception with respect to class action complaints, requiring customers to agree in their account opening documents *not* to pursue class arbitration. *See* NASD Code of Procedure § 3110(f)(5), (6); *see also* Self Regulatory Organizations; Order Granting Approval to Proposed Rule Change as Amended and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 5 by the National Association of Securities Dealers, Inc. Regarding NASD Rule 3110(f) Governing Predispute Arbitration Agreements with Customers, Exchange Act Release No. 34-50713 (Nov. 22, 2004.); According to § 3110, members must provide the following language in predispute arbitration agreements contained in all customer account opening documents:

> (5) If a customer files a complaint in court against a member that contains claims that are subject to arbitration pursuant to a predispute arbitration agreement between the member and the customer, the member may seek to compel arbitration of the claims that are subject to arbitration. If the member seeks to compel arbitration of such claims, the member must agree to arbitrate all of the claims contained in the complaint if the customer so requests.
>
> (6) All agreements shall include a statement that "No person shall bring a putative or certified class action to arbitration, nor seek to enforce any pre-dispute arbitration agreement against any person who has initiated in court a putative class action; or who is a member of a putative class who has not opted out of the class with respect to any claims encompassed by the putative class action until: (i) the class certification is denied; or (ii) the class is decertified; or (iii) the customer is excluded from the class by the Court. Such forbearance to enforce an agreement to arbitrate shall not constitute a waiver of any rights under this agreement except to the extent stated herein."

179 *See generally supra* Part II.B for a discussion of the policy of the FAA.

Congress intended to "reduce the congestion in the Federal and State courts."[180] By forcing claimants to litigate rather than arbitrate class actions, the number of cases on the courts' docket *increases* rather than decreases. The Exclusionary Rule enhances congestion in the courts and runs contrary to the policy of the FAA.

The Exclusionary Rule is also inconsistent with the policy of the FAA as interpreted by the Supreme Court in *Moses*.[181] *Moses* holds that, as a matter of federal law, questions of the scope of arbitrability should be resolved vigorously in favor of arbitration.[182] This is a clear instruction that wherever arbitration is a legally viable alternative, it should be made available.[183] At the time the NASD promulgated the Exclusionary Rule, it was not clear whether class action arbitration was, in fact, a legally viable alternative to litigation.[184] However, in 2003, the Supreme Court determined that class action arbitration *is* consistent with the FAA and is available as a matter of federal law.[185]

Because class action arbitration is consistent with the FAA and there is a strong congressional directive to employ arbitration wherever possible, federal policy implicitly intends for this procedural device to be available. In 2003, after the Supreme Court declared that class action arbitration is consistent with the FAA,[186] the AAA changed its policy to provide for arbitration of class actions.[187] The NASD, however, failed to promulgate new procedural rules in the wake of the decision. By maintaining the preference of litigation over arbitration for the resolution of class action disputes, the NASD has manifestly disregarded the federal directive to favor arbitration where there is legal discretion to do so. Class action arbitration is a legally viable arbitral forum and the NASD has limited rather than expanded its application.

The NASD prohibits class action arbitration because it has made a factual determination that providing the forum would be difficult, duplicative and wasteful. This is an independent evaluation of the economy and efficiency of arbitration and is contrary to the intent of Congress to promote the availability of arbitration wherever possible.[188]

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180 A claimant bound by arbitration is generally precluded from litigating this claim. *See supra* note 10.

181 Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp., 460 U.S. 1 (1983).

182 *Id.*; *see generally supra* Part II.B.2.

183 *See generally supra* Part II.B.2.

184 *See generally supra* Part III.B. NASD Rule 10301(d) was promulgated in 1992. The Supreme Court did not declare class action arbitration available under the FAA until 2003. *See* Green Tree Fin. Corp. v. Bazzle, 539 U.S. 444 (2003).

185 *Id.*

186 *Id.*

187 *See supra* note 152.

188 According to the holding in *Dean Witter*, a court should not substitute its own views of economy and efficiency for those of Congress. Congress decided that, as a matter of federal law, arbitration agreements would be enforceable regardless of whether a court has determined alternatives to be more economical. Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213 (1985).

The NASD has effectively substituted its own views of class action arbitration for those of Congress.[189]

Following *McMahon*[190] and *Rodriguez*,[191] there is no doubt that *all* securities claims are arbitrable under federal law.[192] Under the FAA, there is a jurisprudential presumption that given the force of the congressional mandate in the FAA and the pro-arbitration policy of the United States Supreme Court, class action claims, like any other securities claims, should be arbitrable.[193] The Exclusionary Rule is inconsistent with this federal presumption and contrary to the emphatically pro-arbitration stance of the courts. For this reason, some courts have begun to limit the scope of the NASD's prohibition on class actions. In *Chapman v. Lehman Brothers, Inc.*,[194] for example, the Southern District of Florida ruled that SRO prohibitions on class actions do not encompass collective actions brought pursuant to the Fair Labor Standards Act.[195] The court conducted its analysis expressly in accordance with the *Moses* directive and held that the exclusionary class action arbitration rules should be applied narrowly.[196]

In the past, the NASD has disciplined member firms for attempting to restrict investors' rights with respect to the availability of arbitration.[197] Yet, the NASD itself maintains a policy that restricts investors from accessing a legally viable channel of arbitration. Because the exclusionary rule fails to comport with the principles of the FAA and the prevailing sentiment of the courts, the NASD should

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189 While the NASD is inconsistent with the congressional *intent* and pro-arbitration *policy* of the Act, it is not inconsistent with the plain language of the FAA. When the *Dean Witter* Court held that a court should not substitute its views of efficiency for that of Congress, the Court referred to the enforcement of an arbitration agreement. *Id.* The plain language of the FAA requires an arbitration agreement to be enforced by its terms. *See* 9 U.S.C. § 3 (2000). Since the NASD strictly requires that arbitration agreements between members of the NASD and potential claimants expressly prohibit classwide arbitration in the terms of their predispute agreements, the NASD is simply enforcing the agreement according to its terms. Therefore, while the NASD is not expressly in violation of the *plain language* of the Act, it is in violation of the *spirit* of the Act.

190 482 U.S. 220 (1987).

191 490 U.S. 477 (1989).

192 *See* FLETCHER *supra* note 23, at 148-49.

193 *Id.* ("Indeed the rhetoric of the majority opinions concerning the clarity and strength of the congressional mandate expressed in the Federal Arbitration Act raises the question: is there any type of claim that is not arbitrable?").

194 279 F. Supp. 2d 1286 (S.D. Fla. 2003).

195 *Id.* Given these facts and the strong federal policy in favor of arbitration, the Court held that the rules precluding arbitration of class actions should be narrowly construed and did not encompass collective actions. *Id.* at 1290.

196 *Id.* at 1288.

197 *See* NASD-Press Room-Linda Fienberg Speech, http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013652 (last visited Jan. 22, 2006) (testimony of President of NASD Dispute Resolution Linda D. Fienberg before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises Committee on Financial Services of the House of Representatives on March 17, 2005).

redraft its procedural manual and allow for class action arbitration.

2. Arbitration of Class Claims Would Not Be "Difficult, Duplicative and Wasteful"

Contrary to the argument of the Ruder Request, the administration of class action arbitration by the NASD would not be difficult, duplicative and wasteful. Arbitration of securities claims, under the current paradigm of NASD arbitration, offers claimants substantial advantages over litigation and there is no reason to believe that these benefits would be diluted if pursued on a class basis. Additionally, securities disputes are particularly well-suited for arbitration because a panel of experts rather than a judge would have the institutional competence to evaluate the industry specific issues and arguments that typically arise in such disputes.

In 1992, the NASD was faced with a materially different paradigm of securities arbitration than the one that exists today. At the time the NASD promulgated the Exclusionary Rule, there were criticisms concerning procedural fairness to claimants, no affirmative authority to conduct classwide arbitration under the FAA, and an absence of a proven history of class action administration. In light of these challenges, the NASD's argument that they do not have the procedural expertise to handle class action arbitration is more plausible. Today, however, the foregoing issues have been largely resolved.

The NASD's procedural competence has improved substantially over the last decade through a number of successful internal initiatives.[198] As a testament to the effectiveness of these changes, the number of disputes closed by the NASD has more than doubled since 1992 and claimants have grown to trust and embrace the arbitral process.[199] Further, independent empirical evidence confirms that the NASD currently provides a fair and favorable mechanism of securities dispute resolution for claimants.[200]

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198 *Id.* The NASD has made major improvements in the following areas: transparency for investors, disclosure of arbitrator conflicts of interest, the overall quality of arbitration, selection of neutral arbitrators, removal of arbitrators due to complaints, disclosure compliance, enforcement of awards, and helping investors navigate the arbitral process.

199 *See supra* Part I.B; *see also* Guy Nelson, Note, The *Unclear "Clear and Unmistakable" Standard: Why Arbitrators, Not Courts, Should Determine Whether a Securities Investor's Claim is Arbitrable*, 54 VAND. L. REV. 591, 610 (2001) ("the number of claims filed with the NASD has increased steadily in the past two decades. Resolution of these claims has proceeded apace, and the NASD arbitration process has proven itself a fast and efficient means of dispute resolution. Much of the activity within the NASD arbitral forum derives, perhaps, from a sense of customer confidence in the process.").

200 *See supra* notes 14, 174; *see also* MICHAEL A. PERINO, REPORT TO THE SECURITIES EXCHANGE COMMISSION REGARDING ARBITRATOR CONFLICT DISCLOSURE REQUIREMENTS IN

In addition to the positive developments at the NASD, changes that have occurred in the law itself indicate that it is time for the NASD to amend its exclusionary policy. The Supreme Court, eleven years after the promulgation of the Exclusionary Rule, held that class action arbitration is available under the FAA. The "lack of authority theory" can no longer support the argument that class action arbitration would be difficult, duplicative and wasteful. In fact, the Supreme Court's ruling in *Bazzle* implicitly undermines this argument. The premise of the FAA is to provide for the speedy resolution of disputes, and the Supreme Court has held that class action arbitration is not inconsistent with this goal. Had the Supreme Court found that class action arbitration would be wasteful or merely duplicative, then the Supreme Court would have found a clear conflict with the FAA. Since no such conflict was found, the Supreme Court essentially held that arbitration of class actions would promote the speedy resolution of disputes and would not be wasteful or merely duplicative. Therefore, the Supreme Court implicitly determined that arbitration associations, such as the NASD, would have the procedural competence to administer class action disputes.

Critics of arbitration have proposed that arbitration on a class basis would jeopardize due process protections and would be less effective than individual arbitration.[201] The NASD itself has rejected this argument and stated that arbitration would provide the same due process protections as would a court. Further, it stated that the NASD's arbitrators have the competence and expertise to resolve class-based disputes.[202] Moreover, the NASD rejected the notion that the Exclusionary Rule was promulgated because class claims would take a longer time to arbitrate than would other kinds of claims.[203] The NASD's sole argument supporting the Exclusionary Rule is the vague notion that class actions are "better handled" by the courts. Although class actions would require more procedural hurdles than would individual arbitration, there is no reason to believe that the claimants would be deprived of the general advantages afforded by arbitration, such as the enhanced expectation of recovery, resolution by a panel of neutral experts, application of principles of fairness and equity, and

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NASD AND NYSE SECURITIES ARBITRATIONS (2002), *available at* http://www.sec.gov/pdf/arbconflict.pdf.

201 *See* Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change Relating to the Exclusion of Class Actions From Arbitration Proceedings, Exchange Act Release No. 34-31371, 57 Fed. Reg. 52659, 52660 (Nov. 4, 1992). The comment letter received by the NASD in response to the Rule 10301(d) proposal argued that arbitration of class actions would provide less due process protection thaen the courts, that the benefits of speedy arbitration would not apply on a class basis, and that arbitrators lack the training and expertise to adequately handle classwide proceedings.

202 *Id.*

203 *Id.*

speedy resolution of disputes.[204]

In 1992, there was no proven history for arbitration of class disputes and it was easy to argue that providing for them would be difficult, i.e. not be worth the effort. This theory no longer holds. Following *Bazzle* in 2003,[205] the AAA developed the procedural rules for arbitration claims on a class basis.[206] There are currently almost 100 class claims on the AAA's class case docket, and this number has been increasing steadily since *Bazzle*.[207] For over two years, class action arbitration has been successfully employed by the AAA and this fact alone renders obsolete any notion that class action arbitration is too difficult to manage. If the AAA can effectively accommodate class actions, then surely the NASD, which provides the largest and most extensive securities arbitration forum in the world, can do likewise.

Arbitration of class action securities disputes would not be difficult, duplicative and wasteful relative to litigation because the issues and arguments that arise in securities class action disputes are such that experts, not judges, would have greater institutional competence in evaluating the merits of the claims.[208] Disputes invoking theories such as fraud on the market,[209] the efficient capital market hypothesis,[210] truth on the market,[211] and materiality[212] are heavily

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204 *See supra* note 14.

205 539 U.S. 444 (2003).

206 *See supra* note 153.

207 *Id.*

208 Section 10-B of the Exchange Act and SEC Rule 10-B(5) give private parties rights of action against broker dealers for fraudulent behavior in connection with the purchase or sale of securities. In cases of securities fraud, the claimant has the burden of showing reliance on the deception. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977).

209 *See* Basic Inc. v. Levinson, 485 U.S. 224 (1988). A showing of individual reliance by every member of an entire class of plaintiffs would make the suit impracticable. Instead, the *Basic* Court permits a presumption of reliance, whereby the plaintiff class must show that the market, rather than each individual, relied on the misleading statements or omissions. This is called "fraud on the market."

210 *Id.* In order to prove fraud on the market, the plaintiff class must show that there is an efficient capital market for the disputed security. The efficient capital market hypothesis (ECMH) operates in securities where the market price instantly reflects information disseminated into the marketplace. Certain indicators such as registration of securities under SEC Form S-3 establish a well developed market for a security. Just because a security is publicly traded does not mean that the ECMH is applicable. For example, stocks listed on the Over-the-Counter Bulletin Board Market or the "Pink Sheets" often do not quickly incorporate information into the trading price of the security.

211 *See* Wielgos v. Commonwealth Edison Co., 892 F.2d 509 (7th Cir. 1989). Market reliance in a class action securities case dealing with misrepresentation can be defeated if a defendant can show that the market did not in fact rely on the misrepresentation, but rather that it knew the truth. This is called the "truth on the market" theory.

212 *See* TSC Indus. v. Northway, Inc., 426 U.S. 438, 440 (1976). The standard for materiality set by the Supreme Court in *TSC* is objective and involves information that a reasonable investor would consider important, such as information that would affect a reasonable investor's judgment. The reasonable investor need not decide differently based on these facts, but rather value this information as something she would like to know in making an investment decision.

dependent upon an accurate understanding of the securities world and market forces. Arbitration offers advantages over litigation in the resolution of these disputes.

In litigation of class action claims, judges and juries would have to rely on experts hired by the parties to the dispute in order to evaluate the merits of securities claims.[213] Educating the judges and juries costs money and takes time. Further, since the experts are called by a party with a stake in the dispute, the judges and juries may receive a distorted picture of the facts. Because arbitration panels are comprised of industry experts and public arbitrators, arbitration will require less education and arbitrators are less likely to be duped by paid testimony from hired experts.[214]

C. A Proposal for Changing the NASD Code to Allow for Class Arbitration

A proposal allowing for class action arbitration should be acceptable to the SEC under the Exchange Act. The Exchange Act requires that the NASD's rules protect investors and advance the public interest.[215] Arbitration of securities claims on a class basis avails claimants of various procedural advantages that litigation does not offer.[216] Because arbitration of securities claims better protects class action claimants than litigation and is not merely duplicative to litigation, it is in the public's interest to propose new rules to the SEC allowing for class action arbitration.[217] The threshold requirements of the Exchange Act are met and the SEC has the statutory authority to accept proposed regulations in favor of class action arbitration.[218]

The NASD should repeal the Exclusionary Rule and require arbitration of class claims. Because arbitration is favorable for claimants, it is unlikely that, given a choice, broker-dealer members would opt to select class action arbitration over litigation in drafting their pre-dispute adhesion agreements. Therefore, the default rules concerning mandatory arbitration of "any" disputes should be read to include class actions. All of the prohibitive language in the Exclusionary Rule and in Rule 3110(f)(5)-(6) concerning class actions

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213 *See supra* notes 36-40 and accompanying text.

214 *Id.*

215 *See supra* note 16.

216 *See supra* note 14.

217 *Id.*

218 *See supra* note 16; *see also* Self-Regulatory Organizations; Notice of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Improvements in the NASD Code of Arbitration Procedure, Exchange Act Release No. 34-30882, 51 S.E.C. Docket 1340 (July 1, 1992).

should be abrogated.

There are several resources from which to draw upon express language to redraft the Code to provide for class actions. In the absence of any express provisions, the default rules of the NASD should apply. For express language concerning procedures specific only to class actions, FRCP 23 should provide an appropriate framework from which to start. The AAA, for example, has adopted the spirit of Rule 23 in drafting its procedural rules specific to class action arbitration.[219] Additionally, the Private Securities Litigation Reform Act of 1995 (PSLRA)[220] was designed to curb class action abuses by the plaintiff's bar.[221] The PSLRA contains effective measures such as limitations on attorney's fees to a reasonable percentage of class recovery and the rebuttable presumption that the class representative should be the party with the largest claim.[222]

CONCLUSION

The NASD originally adopted the Exclusionary Rule to end the unfair defendant practice of decertifying class claims by enforcing separate, individual arbitration agreements. Due to criticisms of NASD arbitration's procedural fairness, no proven record of class action arbitration and no affirmative authority to conduct class action arbitration under the FAA, the NASD chose litigation rather than arbitration for the resolution of class action disputes. In doing so, the NASD implemented a policy inconsistent with the FAA. The reasoning for originally choosing litigation over arbitration in drafting the rule no longer has merit. Further, there is empirical evidence that arbitration offers procedural advantages to claimants over litigation and it would be in the public's interest to provide for arbitration of class actions. In conclusion, the NASD should discontinue its practice of prohibiting arbitration of class disputes.

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219 *See* American Arbitration Association, Supplementary Rules for Class Arbitrations, http://www.adr.org/sp.asp?id=21936 (last visited Dec. 6, 2006) (rules became effective on October 8, 2003).

220 Pub. L. No. 104-67, 109 Stat. 743 (1995).

221 *See* Adam C. Pritchard, *Should Congress Repeal Securities Class Action Reform?*, POLICY ANALYSIS NO. 471, at 6 (Feb. 27, 2003).

222 *Id.* at 6-7.