
Margaret M. Harding

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THE CAUSE AND EFFECT OF THE ELIGIBILITY RULE IN SECURITIES ARBITRATION: THE FURTHER AGGRAVATION OF UNEQUAL BARGAINING POWER

Margaret M. Harding*

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Arbitration is widely accepted as providing an adequate process of dispute resolution. Indeed, there is a federal policy favoring arbitration, as manifested by the case law interpreting the Federal Arbitration Act (FAA).\(^1\) For many, arbitration may provide the only avenue to justice. For others, it may provide the only efficient means of obtaining justice. Arbitration, at least theoretically, is less expensive, less time-consuming and simpler than litigation in a judicial forum.\(^2\)

The wholesale adoption of arbitration as an adequate dispute resolution process is not, however, without its problems. While the general framework of arbitration may be deemed adequate to protect the rights of most parties in the arbitral forum, the specific procedures applicable in that forum may not. The blanket endorsement of arbitration cannot immunize those specific procedures from review to ensure their fairness, particularly when one of the parties is in arbitration because of unequal bargaining power. The inequality that may result from the uncritical acceptance of the specific rules and procedures governing arbitration is exemplified by arbitration in the securities industry.

Arbitration is now the primary method used for the resolution of disputes between investors and broker-dealers relating to the purchase and sale of securities.\(^3\) Most of those arbitrations take place in securities industry-sponsored arbitral forums,\(^4\) and, for most investors, arbitration is compulsory.\(^5\)

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1. 9 U.S.C. §§ 1-16 (1994); see infra notes 90-113 and accompanying text (discussing the history and purposes of the FAA).
2. See, e.g., Lynn Katzler, *Should Mandatory Written Opinions Be Required in All Securities Arbitrations?: The Practical and Legal Implications to the Securities Industry*, 45 AM. U. L. REV. 151, 197 n.227 (1995) (citing a study that revealed that the average securities arbitration costs $12,000 less than a court proceeding and takes less time to conclude).
3. See infra notes 43-56 and accompanying text (discussing the increasing use of SRO arbitral forums).
4. The national securities exchanges, such as the New York Stock Exchange, Inc. (NYSE) and the American Stock Exchange, Inc. (AMEX), as well as the National Association of Securities Dealers, Inc. (NASD), all commonly referred to as self-regulatory organizations (SROs), sponsor the arbitral forums. See infra notes 57-88 and accompanying text (discussing the procedures used in SRO arbitration).
5. The fact that the securities industry is itself providing the arbitration facilities and that the industry requires investors to use those same facilities if the investor has a dispute with a broker-dealer has caused many to question the independence and fairness of SRO arbitration. See infra notes 32-42 and accompanying text.
6. When opening up a margin or options account with a broker-dealer, most investors are required to sign an agreement containing a clause obligating them to arbitrate at an SRO arbitral forum all future controversies with the securities firm and with the individual broker-dealer. See infra notes 48-51 and accompanying text.
With arbitration as the mainstay of dispute resolution for controversies between investors and broker-dealers, much attention has been focused on whether the investor is getting a fair shake in the industry-sponsored arbitral forum. The conclusion, while not overwhelming and certainly not indisputable, is that investors fare as well in SRO arbitration as they would fare in an arbitral forum sponsored by an organization deemed more independent of the securities industry or in a judicial forum. This result, while comforting on some level, however, cannot end the inquiry into the fairness of SRO arbitration for it fails to take into account the investor who is barred from arbitration because the investor’s claim is deemed ineligible according to the eligibility rule, a rule of procedure adopted by the SROs which requires the submission of a claim to arbitration within six years from the date of the occurrence or event giving rise to it. The consequence of having a claim found ineligible for SRO arbitration is that the investor is completely deprived of a forum through which to seek redress for his or her otherwise viable claim. Most courts that have addressed the effect of having an ineligible claim have interpreted contract language and SRO arbitration rules of procedure to bar the investor from litigating the claim in both an arbitral and a judicial forum. This result is contrary to controlling federal law, further aggravates the unequal bargaining power between the investor and the broker-dealer and rewards the unscrupulous broker-dealer who can successfully conceal his or her wrongdoing.


7. For example, the American Arbitration Association (AAA) is a not-for-profit organization that provides arbitration services for a variety of disputes, including disputes related to the purchase and sale of a security. American Arbitration Association, Securities Arbitration Rules (1993).

8. See infra notes 439-49 and accompanying text (discussing SRO arbitration versus a judicial forum or AAA securities arbitration).

9. See infra notes 216-42 and accompanying text (discussing the eligibility rule and its origins).

10. See infra notes 356-413 and accompanying text (discussing the consequences of a finding of ineligibility).
When the Supreme Court blessed SRO arbitration as an alternative for the resolution of disputes between investors and broker-dealers, it did so partly on the presumption that customers do not give up substantive rights when agreeing in advance to arbitrate a dispute. The eligibility rule, however, as interpreted and applied by the courts and the SROs, results in the loss of the most basic of substantive rights: the right to seek redress for wrongful conduct, a right the investor would have had but for the SRO eligibility rule. If such a result were indeed compelled by the plain meaning of the SRO procedural rules and by the contract language, the legitimacy of SRO arbitration, and the Supreme Court's endorsement of it, would have to be seriously questioned. That result, however, is not compelled. The SRO arbitration rules as a whole and the intent of the parties to the arbitration agreement provide bases for the courts upon which to interpret the eligibility rule in a manner that will protect the rights of the investor.

Due to the unequal bargaining position of investors, courts should be obligated to give the SRO rules and the contract between the parties an interpretation that will preserve, rather than destroy, the substantive rights of investors when compelled to go to arbitration. If the failure to protect investors' rights continues, the health of our capital markets may ultimately be affected. And if the relinquishment of the right to bring an otherwise timely action against a broker-dealer is not enough to deter investors from investing, it may be enough to cause them to shun arbitration when and if they can, and thereby deprive themselves of the benefits of an alternative dispute resolution procedure that can, if done properly, provide quick and inexpensive justice. Alternatively, they may forfeit their claims altogether, which, of course, would undermine the goals of the federal securities laws.


12. As aptly stated by Professor Constantine N. Katsoris in the forward to the NYSE Symposium on Arbitration in the Securities Industry: "The public's perception of fairness, however, must be zealously guarded, for it extends far beyond the issue of arbitration. It goes to the very heart of the public's trust in the securities markets themselves. This trust must be preserved for those markets to stay healthy." New York Stock Exchange, Inc. Symposium on Arbitration in the Securities Industry, 63 Fordham L. Rev. 1499, 1502 (1995) [hereinafter NYSE Symposium]; see also Gregory & Schneider, supra note 6, at 1224 ("[T]he investing public perceives forced arbitration of their disputes with brokers as inherently unfair, which undermines the integrity of the financial markets and serves to impede the flow of capital upon which our economic system depends."); Settling Disputes Between Customers and Registered Brokers and Dealers, Exchange Act Release No. 12528, 9 S.E.C. Docket 833 (June 9, 1976) (indicating that an efficient system for the resolution of disputes will contribute to the increased participation of individual investors in the securities markets).
This article will first describe SRO arbitration, its prevalence in resolving disputes between investors and broker-dealers, and the history of the enactment of uniform procedural rules to govern such disputes. It will then trace the Supreme Court's endorsement of SRO arbitration and the impact of the evolving jurisprudence of the FAA on that endorsement. The change in the Court's attitude from one of hostility to one of acceptance and endorsement of arbitration will be analyzed as well. The article will then examine the eligibility rule, one of the procedural rules applicable in all SRO arbitral forums. It will focus on two separate issues: (i) who should decide eligibility, the judge or arbitrator; and (ii) what the consequences should be to an investor whose claim has been found ineligible according to SRO rules of procedure. It will be argued that, consistent with federal law, the arbitrator, and not the court, should make the determination regarding the eligibility of the investor's claim. The astounding consequence of a finding of ineligibility will then be examined. It will be argued that the courts are improperly depriving the investor with an ineligible claim the right to proceed with that claim in a judicial forum. The inconsistency in the courts' treatment of the contract language in deciding the two issues will also be highlighted. The article will then discuss the position of the Securities Industry Conference on Arbitration (SICA), the original drafter of the eligibility rule, on these two issues and will demonstrate how the SROs are improperly refusing to adopt SICA's position. The Securities and Exchange Commission's (SEC) position, or, more appropriately, the lack thereof, will also be examined and studies concerning the fairness of SRO arbitration will be discussed to the extent of demonstrating that such studies are indeed not a reliable indication of fairness with respect to the investor with an ineligible claim. The article will conclude with a suggestion, borrowed from federalism jurisprudence, as to how the procedural rules of the arbitral forum should be analyzed to ensure that such rules do not tread upon state or federally created substantive

13. See infra parts II.A-B.
14. See infra parts III.A-B.
15. See infra parts III.A-B.
16. See infra parts IV.A-B.
17. See infra parts IV.B.1-4.
18. See infra part IV.B.1.
19. See infra part IV.B.2.
20. See infra part IV.B.2.
21. See infra part IV.B.2.
22. See infra part IV.B.3.
23. See infra part IV.B.3.
24. See infra parts IV.B.4-5.
It will be argued that the Supreme Court's endorsement of SRO arbitration generally should not immunize specific procedural rules, such as the eligibility rule, from examination. That argument will treat the SRO arbitral forum, with its "consensual jurisdiction," as the equivalent of a state or federal forum and will suggest that the arbitral forum also be subject to the rule that prohibits each forum from adopting procedural rules that effectively deprive a party of a substantive right.

II. SRO Arbitration

Arbitration administered by an SRO has been around for almost 125 years, becoming more common among SROs in the last 35 years. However, it was not until the Supreme Court's decision in Shearson/American Express v. McMahon, where the Court, by upholding the use of predispute agreements to arbitrate violations of section 10(b) of the Exchange Act, embraced and legitimized arbitration administered by the SROs, that the fairness of such arbitration began to be seriously questioned by, among others, legal scholars.

25. See infra part V.
26. See infra part V.
27. See infra part V.
SROs are part of the Exchange Act's dual system of regulation. With SEC oversight, the SROs registered with the SEC are responsible for policing the conduct of their members by enforcing the SRO's own rules as well as the securities laws. SROs also monitor trading in the markets, propose rules to the SEC regarding the administration of their organizations, and, as discussed, provide arbitration facilities. General Accounting Office, Pub. No. GGD-92-94, Securities Arbitration: How Investors Fare 104 (May 11, 1992) [hereinafter GAO Report] (technical comments of the SEC Division of Market Regulation). See generally Exchange Act § 19, 15 U.S.C. § 78s (1994).
29. PHILIP J. HOBLIN, JR., SECURITIES ARBITRATION PROCEDURES, STRATEGIES, CASES 1-2 (2d ed. 1992) (stating that the NYSE began offering arbitration for the resolution of disputes between its members and their customers in 1872).
30. Id. In 1964, nearly 100 years after the NYSE began administering its arbitration program, AMEX followed suit. Id. The NASD began its program in 1968. Id.
In addition to the NYSE, AMEX and the NASD, the Chicago Board of Options Exchange, the Municipal Securities Rule Board and the Boston, Chicago, Pacific and Philadelphia Stock Exchanges also administer arbitration programs. Securities Industry Conference on Arbitration, Eighth Report of the Securities Industry Conference on Arbitration to the Securities and Exchange Commission 2 (June 1994) [hereinafter Eighth Report].
32. See supra note 6 and accompanying text (discussing the opinions of legal scholars regarding SRO arbitration).
members of Congress, and state legislators. That questioning continues today. While it is unsettling that the fairness of SRO arbitration with respect to state statutory and common law claims, which claims were already being arbitrated in SRO forums, was not addressed earlier, it is understandable that the McMahon decision caused the issue to come to the forefront. McMahon "revolutionize securities litigation" and required arbitration of thousands of cases at industry-sponsored and paid-for arbitral forums according to industry rules. The sheer volume of cases is not the only reason why securities arbitration has come under greater scrutiny than general commercial or labor arbitration. The difficulty and complexity of the issues involved and the mandatory nature of the predispute arbitration clause are additional reasons. However, the principal


34. In response to McMahon, Massachusetts enacted legislation regulating the use of predispute arbitration clauses. Gregory & Schneider, supra note 6, at 1244. That legislation was struck down as preempted by the FAA. Securities Indus. Ass'n v. Connolly, 883 F.2d 1114, 1120 (1st Cir. 1989), cert. denied, 495 U.S. 956 (1990).

35. See generally NYSE Symposium, supra note 12.


37. See NYSE Symposium, supra note 12, at 1507 (stating that securities arbitration was transformed overnight from a voluntary procedure to a mandatory obligation) (panelist Professor Katsoris).

38. Norman S. Poser, When ADR Eclipses Litigation: The Brave New World of Securities Arbitration, 59 BROOK. L. REV. 1095, 1107 (1993). The circumstances typically surrounding the execution of the agreement to arbitrate in the commercial or labor context are in marked contrast to those surrounding an investor's execution of the arbitration agreement. In the commercial and labor context, the agreement containing the arbitration clause is mutually negotiated and may even be mutually drafted. In the securities context on the other hand, the investor plays no role whatsoever in the drafting or even the negotiation of the agreement. Id. at 1096.


40. See infra notes 45-51 and accompanying text (discussing the use of mandatory predispute arbitration clauses with individual investors).
reason seems to be that an overwhelming number of securities arbitrations take place at SRO administered forums. \(^4\) The perceived lack of independence of these arbitration programs has caused many to question their overall fairness to investors. \(^42\)

### A. Widespread Use of SRO Arbitral Forums

The vast majority of disputes between an investor and a broker-dealer are resolved in an SRO arbitral forum. \(^43\) This is because most securities firms require their customers, as a precondition to doing business with the firm, to sign a Customer Agreement or other document agreeing to arbitrate before an SRO arbitral forum any dispute he or she may have with the broker-dealer or the securities firm. \(^44\)

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\(^{41}\) See infra notes 53-56 and accompanying text (discussing the increase in arbitrations between 1980 and 1994).

\(^{42}\) The concern over the lack of independence of SRO arbitral forums led the Chairman of the House Committee on Energy and Commerce and its Subcommittee on Telecommunications and Finance and the Chairman and four members of the Senate Committee on Banking, Housing and Urban Affairs to request that the General Accounting Office (GAO) compare arbitration awards rendered at SRO arbitral forums and compare the results with securities arbitration awards rendered at the AAA to determine if there was industry bias. GAO Report, supra note 28, at 4; see infra notes 444-49 and accompanying text (discussing the results of the GAO study).

The public's perception of unfairness also caused the securities industry itself to evaluate whether it should create a single independent arbitral forum. Katsoris, Should McMahon Be Revisited?, supra note 6, at 1121. It has also caused the SEC to encourage broker-dealers to include the AAA in the choice of forums granted to the investor in the predispute arbitration clause. Securities Uniformity; Annual Conference on Uniformity of Securities Law, Securities Act Release No. 6883, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) \$ 84,715 (Mar. 12, 1991). This was done even though the SEC has no oversight authority over the AAA. Katsoris, The Level Playing Field, supra note 6, at 470.

\(^{43}\) See, e.g., Report of the Arbitration Policy Task Force to the Board of Governors National Association of Securities Dealers, Inc., reprinted in Fed. Sec. L. Rep. (CCH) [1995-1996 Transfer Binder], \$ 87,735, at 87,433 (Mar. 6, 1996) [hereinafter Task Force Report] (noting that arbitration is the principal means of resolving disputes between investors and securities firms); see also GAO Report, supra note 28, at 4 (finding that arbitration is the most frequently used method of resolving securities disputes); Hearings, supra note 33, at 476 ("SRO sponsored arbitration [has] become[ ] the principle forum for the resolution of investor grievances against their brokers.") (statement of David S. Ruder, former Chairman of the SEC).

\(^{44}\) See, e.g., GAO Report, supra note 28, at 28-30 (finding that arbitration agreements are preconditions to opening a customer account); Task Force Report, supra note 43, at 87,433-34; Grant, supra note 6, at 395; Gregory & Schneider, supra note 6, at 1228; Constantine N. Katsoris, The Arbitration of a Public Securities Dispute, 53 FORDHAM L. REV. 279, 292 (1984) (recognizing that such agreements are conditions to opening an account); NYSE Symposium, supra note 12, at 1513, 1519 (panelists Theodore A. Kresbach and Theodore E. Eppenstein, respectively) (both panelists acknowledging that brokerage firms require investors to sign predispute arbitration agreements as a condition to doing business); Margo E. K. Reder, Securities Law and Arbitration: The Enforceability of Predispute Arbitration Clauses in Broker-Customer Agreements, 1990 COLUM. BUS. L. REV. 91, 96 (noting that customer agreements usually require arbitration before an industry-sponsored association); Susan Antilla, At the Bar; Brokerage Firms Steer Dissatisfied Customers Away From Court But In Only One Direction, N.Y. TIMES, May 12, 1995, at A29.
In 1992, the GAO surveyed small, medium and large firms regarding their use of predispute arbitration clauses. With respect to individual investors opening cash accounts after December 1, 1990, a substantial minority of small and medium firms required the signing of an agreement containing an arbitration clause; a small percentage of large firms required it. The numbers were significantly higher with respect to margin and options accounts: all large firms, ninety percent of medium firms, and over seventy percent of small firms required customers to sign agreements containing predispute arbitration clauses. Large securities firms requiring the signing of a predispute arbitration clause seldom gave the investor the choice of the AAA as a forum; medium firms did more often.

These numbers make it clear that the customer buying on margin or opening an options account really has no choice but to agree to arbitrate before an SRO forum. While that customer may try opening an account with another securities firm, his or her options are clearly quite limited. Furthermore, any attempt to negotiate a waiver of the arbitration clause itself will not be successful. The GAO Report found that most securities firms never or almost never waived or negotiated the clause with individual investors.

The practice among the securities firms of requiring execution of an agreement to arbitrate future controversies at an SRO arbitral forum as a precondition to doing business, which has been upheld by the Supreme Court, has resulted in a staggering number of arbitrations being conducted at SRO forums. In 1980, SROs handled 830 arbitral forum arbitrations.

45. GAO Report, supra note 28, at 22. The size of the firm was categorized on the basis of its number of registered retail representatives. Id.

46. Thirty-seven percent of small firms and forty-six percent of medium firms required the customer to agree to arbitrate when opening a cash account. Id. at 28-29.

47. Only eleven percent of large firms required cash account customers to sign an arbitration agreement. Id.

48. Id. at 31-32. The number of investors signing predispute arbitration agreements is expected to increase with the increase in the use of custody accounts, which most investors will sign to ensure timely settlement of trades. Task Force Report, supra note 43, at 87,436.

49. GAO Report, supra note 28, at 31-32.

50. See, e.g., NYSE Symposium, supra note 12, at 1519 (noting that most big brokerage firms have the same policies concerning arbitration).

51. GAO Report, supra note 28, at 30. The GAO Report found that in 1990 the one large firm that required its individual investors to sign cash account agreements containing the predispute clause almost never waived or negotiated it. Id. Seventy-five percent of the medium firms and ninety-six percent of the small firms that required cash account customers to sign the clause reported that they never or almost never waived or negotiated the clause. Id. For margin and options accounts, over seventy-five percent of the firms, regardless of size, never or almost never, waived or negotiated the clause. Id.; see also NYSE Symposium, supra note 12, at 1519.

That number increased by almost 800 percent in 1994, bringing the number of cases to 6,486. The AAA handled an additional 274 cases, only 4.2 percent of the total number of arbitrations filed with the SROs in 1994.

**B. Procedures Used in SRO Arbitrations**

The predispute arbitration clause will typically give the customer the choice of two or more SRO forums and will indicate that the arbitration procedures of the chosen forum will govern the dispute. Regardless of that choice of forum, however, the procedures that will

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54. This figure does not include the number of filings at the Philadelphia Stock Exchange and the Chicago (Midwest) Stock Exchange, for which numbers were unavailable. Deborah Masucci & Robert S. Clemente, *Securities Arbitration at the New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.—Administration and Procedures*, at 291, 298 (PLI Corp. Law and Practice Course Handbook Series No. 899, 1995).

55. George H. Friedman & Florence M. Peterson, *When You Have a Choice of Forum: The Differences Between Securities Arbitration at the AAA and the SROs*, at 555, 559 (PLI Corp. Law and Practice Course Handbook Series No. 899, 1995). The number of filings at the AAA in 1994 drastically decreased from an all time high of 635 filings in 1993. *Id.* Brokerage firm restriction of the AAA as a choice of forum in form contracts is one reason attributed to the decline in cases filed with the AAA. *Id.* The AAA's securities arbitration program may be abandoned if filings do not increase. *Task Force Report, supra* note 43, at 87,436 n.12.

56. As the following chart demonstrates, during the last decade the percentage of securities cases handled by the AAA never exceeded more than ten percent of the total number of cases handled by the SROs. The recent dramatic drop in the securities cases filed with the AAA in 1994 basically puts the AAA back into the position it held in the mid-1980's—before the Supreme Court's blessing of arbitration for claims based on the federal securities laws.

<table>
<thead>
<tr>
<th>SRO Composite Figures</th>
<th>AAA Figures/Percentage of SRO Total</th>
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<tbody>
<tr>
<td>1986</td>
<td>2,837</td>
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<tr>
<td>1987</td>
<td>4,357</td>
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<tr>
<td>1988</td>
<td>6,097</td>
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<tr>
<td>1989</td>
<td>5,404</td>
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<tr>
<td>1993</td>
<td>6,561</td>
</tr>
<tr>
<td>1994</td>
<td>6,486</td>
</tr>
</tbody>
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See Eighth Report, *supra* note 30, at 29 (providing the SRO Composite Figures) and George H. Friedman, *Discovery in Arbitration*, at 389, 391 (PLI Corp. Law and Practice Handbook Series No. 899, 1994) (providing the AAA Figures).

57. See J. Kirkland Grant, *Securities Arbitration for Brokers, Attorneys, and Investors 80-81* (1994) (including a standard client agreement containing a predispute arbitration clause); *see also* Notice to Broker-Dealers Concerning Clauses in Customer Agreements which Provide for Arbitration of Future Disputes, Exchange Act Release No. 15984 [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,125, at n.4, (July 2, 1979) (noting that a typical arbitration agreement allows the investor to choose from a list of several arbitration organizations). It is the SEC's position and the rules of the various SROs to allow a customer to arbitrate any claim against any firm or industry professional at any SRO at which that firm or professional is a member. Roney & Co. v. Goren, 875 F.2d 1218, 1222-23 (6th Cir. 1989).
govern the arbitration will, for the most part, be the same. All SROs that sponsor arbitration programs have adopted, with the approval of the SEC, the Uniform Code of Arbitration (UCA)\textsuperscript{58} developed by SICA, a task force created by the securities industry for the purpose of responding to SEC concerns over the lack of uniformity in the rules governing arbitration among the various SROs.\textsuperscript{59}

The SEC, in response to a directive from President Ford regarding regulatory reform and agency responsiveness to consumers,\textsuperscript{60} created the Office of Consumer Affairs and empowered it to study and make recommendations to the SEC with respect to the development of a "model and uniform system of dispute grievance procedures for the adjudication of small claims."\textsuperscript{61} The SEC also sought comments on the development of such a program from the public.\textsuperscript{62}

The Office of Consumer Affairs made certain recommendations to the SEC for the resolution of small dollar amount claims.\textsuperscript{63} Specifically, the Office recommended, among other things, that a new, "quasi-independent" entity be established by the SROs to administer

\begin{footnotesize}

59. See infra notes 73-76 and accompanying text (discussing that SICA was created by the securities industry and was initially composed of representatives from ten SROs, the SIA and three members of the public). For a history of SICA, see Constantine N. Katsoris, \textit{SICA: The First Twenty Years}, 23 FORDHAM URB. L.J. 483 (1996) [hereinafter Katsoris, \textit{SICA}].


61. \textit{Id.} The Commission clearly expected that a uniform system would accomplish more than just the resolution of small claims between investors and broker-dealers:

\begin{quote}
The establishment of an efficient system for resolving disputes involving small sums should contribute significantly to the protection of investors (which is the objective of the federal securities laws), to the increased participation of individual investors in the securities market (which the securities industry has often encouraged), and to the conduct of a securities business in a manner that observes high standards of commercial honor \ldots and that promotes just and equitable principles of trade.
\end{quote}

\textit{Id.} at 834.

62. \textit{Id.}

\end{footnotesize}
a system of professional small-claims adjusters, who would be empowered to make settlement offers to consumers. The SEC agreed in principle with the dispute resolution system suggested by the Office of Consumer Affairs. However, before the SEC commenced rule-making proceedings or requested that the SROs amend their own rules to provide for such a system, it sought comments from all interested persons on the proposal.

The comments the SEC received caused it to abandon implementation of the program proposed by the Office of Consumer Affairs. Instead, the SEC deferred to the securities industry itself the job of developing and implementing a nationwide system for dispute resolution. Apparently, the views expressed at a public forum favored an industry-sponsored dispute resolution system instead of the creation of the “quasi-independent” administrative agency proposed by the Office of Consumer Affairs.

The NYSE and the NASD proposed that a conference or a task force be created with industry representatives and members of the public to develop a single system for the resolution of customer disputes. Although it had extensive authority over the SROs, the SEC

64. Id.
65. Id.
66. The Exchange Act empowers the SEC to amend the rules of the SROs:

   The Commission, by rule, may abrogate, add to, and delete from . . . the rules of a self-
   regulatory organization . . . as the Commission deems necessary or appropriate to in-
   sure the fair administration of the self-regulatory organization, to conform its rules to
   the requirements of this chapter and the rules and regulations thereunder applicable to
   such organization, or otherwise in furtherance of the purposes of this chapter . . . .


   This provision was added to the Exchange Act in 1975 to clarify and strengthen the SEC's
   oversight authority over the SROs. S. REP. No. 75, 94th Cong., 1st Sess. 22, 31 (1975) reprinted
   in 1975 U.S.C.C.A.N. 179, 200, 209; see also Catherine McGuire & Robert A. Love, Dispute
   Resolution Between Investors and Broker-Dealers in the United States Securities Markets, 14 Has-
   tings INT'L & COMP. L. REV. 431, 434 (1990) (stating that due to section 19, the SEC has exer-
   cised broad oversight authority over SRO arbitration).

   Release No. 13470]. The Commission stated: “Although the Commission does have extensive
   authority over the self-regulatory organizations, their rules and procedures, . . . it is of the view
   that it would not be useful at this time to interpose itself in this area since the industry has
   manifested its intention to take affirmative action.” Id. at 87,907.

69. Id.
70. Id. The purpose of the conference would be to:

   [C]onsider how the securities industry can respond to the Commission's concerns that
   there be more effective, efficient and economical dispute resolution procedures avail-
   able to individual investors, including a uniform arbitration code and procedures, a
   simplified system for the resolution of disputes involving small dollar amounts, and
agreed to defer its own action on the assumption that: (i) investors, or their representatives, would be included in the conference; (ii) the conference byproduct would be one which would implement a simplified nationwide system for dispute resolution along the lines set out by the SEC; and (iii) the proposed system would be in the public interest. If the securities industry failed to achieve the SEC's objectives, the SEC indicated that it would take action as appropriate to implement a nationwide dispute resolution system. As it turned out, the SEC did not have to take action. In April 1977, SICA, composed of representatives from the ten SROs, a representative of the Securities Industry Association (SIA) and three members of the public, was formed and it carried out the SEC's objectives. The consequence of SICA satisfying the SEC's objectives, of course, was the complete abandonment of the plan proposed by the Office of Consumer Affairs and, with that abandonment, went any hope that investors may have had of having an independent, or even "quasi-independent," agency to resolve their disputes.

As requested, SICA developed streamlined uniform procedures for the arbitration of small dollar amount claims. Thereafter, SICA developed the UCA for the resolution of all disputes, regardless of dol-

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Id.

71. Release No. 13470, supra note 68.

72. Id.


74. Id.

75. Id. Peter R. Cella, Jr., Mortimer Goodman and Professor Constantine N. Katsoris were selected as the public members because of their experience and interest in securities arbitration. Id. An additional public member was added in 1983. Katsoris, Should McMahon Be Revisited?, supra note 6, at 1117 n.27. The fact that the representatives from the securities industry and its trade association overwhelmingly outnumbered the members of the public apparently did not concern the SEC.

76. Second Report, supra note 73, at 2.

77. Grant, supra note 6, at 482.


79. See Grant, supra note 6, at 482 (indicating that SICA went beyond the SEC's original plan to provide uniform procedures for small dollar amount claims when it adopted the UCA for the resolution of all disputes); see also Katsoris, The Level Playing Field, supra note 6, at 427-29.
lar amount,\textsuperscript{80} which was adopted by all SROs\textsuperscript{81} and approved by the SEC.\textsuperscript{82} In approving SRO adoption of the UCA, the SEC found it to be consistent with the requirements of the Exchange Act, particularly with section 6(b)(5), which requires that the rules of an Exchange promote "just and equitable principles of trade."\textsuperscript{83} SICA did not disband upon the completion of the UCA. Rather, SICA has continued "to review the operations of the Code and SRO arbitration and to consider amendments in light of experiences of the users of arbitration, to evaluate and respond to case law and other developments in arbitration, and to consider suggestions of the public and the SEC."\textsuperscript{84}

The SEC considered the development of the UCA by SICA to be a substantial improvement over the procedures that were being used by the various SROs and an important step toward the establishment of a uniform system.\textsuperscript{85} Professor Katsoris has analogized SICA to the

\begin{itemize}
  \item See generally Second Report, supra note 73, at 5-6. Prior to the adoption of the UCA, arbitration procedures varied from forum to forum. Katsoris, \textit{The Level Playing Field}, supra note 6, at 424-26. The UCA "incorporated and harmonized the rules of the various SROs and codified procedures" previously followed by SROs but not part of their formal rules. \textit{Id.} at 429.
  \item See supra note 58 and accompanying text (discussing the adoption of the UCA by all SROs). As a member of SICA, an SRO is not obligated to agree with or adopt everything SICA proposes. Each individual SRO must make a determination as to whether to adopt a rule proposed by SICA. \textit{Id.} There have been instances where no SRO has adopted an amendment to the UCA as proposed by SICA. See \textit{infra} note 419 and accompanying text.
  \item See supra note 58 and accompanying text (discussing the approval of the UCA by the SEC). If an SRO wishes to make a change to its rules governing arbitration, it must file with the SEC the proposed rule change. Exchange Act \S\ 19(b)(1)-(b)(2), 15 U.S.C. \S\ 78s(b)(1)-(b)(2) (1994). Upon receipt, the SEC will publish notice of the proposed rule change and will give interested persons an opportunity to comment. \textit{Id.} Thereafter, the SEC will either approve the change or institute proceedings to determine whether it should be disapproved. \textit{Id.} The SEC may not approve an SRO rule change unless it is consistent with the objectives of the Exchange Act. \textit{Id.}
  \item Eighth Report, supra note 30, at 3; see also Katsoris, \textit{Should McMahon Be Revisited?}, supra note 6, at 1119 (noting that it was necessary for SICA to continue to monitor the arbitration process). For example, SICA proposed numerous changes to the UCA following the \textit{McMahon} decision, some of which were prompted by the SEC itself. Changes were made to the rules regarding, among other things, discovery, awards, records of the proceedings and prehearing conferences. Grant, supra note 6, at 508-19.
  \item See Release No. 16390, supra note 83, at 1199. The SEC was obviously pleased enough with the UCA to abandon the plans developed by its own Office of Consumer Affairs.
\end{itemize}
“cop on the beat,” whose stabilizing influence, and whose attempt to level the playing field between investors and broker-dealers has “re-injected investor confidence in the SRO arbitration system.”

The creation of SICA, the development of the UCA and the SEC’s oversight of SRO arbitration rules undoubtedly played a role in the Supreme Court’s endorsement of SRO arbitration for the resolution of claims based on the federal securities laws. Even Justice Blackmun in his dissenting opinion in McMahon conceded that SRO arbitration had improved in the almost thirty-five years since the Supreme Court first prohibited the arbitration of Securities Act claims. He stated: “It is true that arbitration procedures in the securities industry have improved since Wilko’s day. Of particular importance has been the development of a code of arbitration by the Commission with the assistance of representatives of the securities industry and the public.”

III. THE SUPREME COURT’S ENDORSEMENT OF SRO ARBITRATION

In order to understand and analyze the Supreme Court’s endorsement of SRO arbitration, it is first necessary to review generally the FAA and the history of its impact on securities arbitration.

A. The FAA

The FAA was enacted in 1925 to end judicial hostility to predispute arbitration agreements. Before the FAA’s enactment, agreements to arbitrate a future controversy, or predispute arbitration agreements, were revocable up until the time the arbitrators made their award. The FAA made agreements to arbitrate enforceable in fed-

86. Katsoris, Should McMahon Be Revisited?, supra note 6, at 1152.
91. S. Rep. No. 536, supra note 90, at 2. The reluctance of American courts to enforce agreements to arbitrate has been traced back to the English common law. English courts permitted revocation due to the fear that enforcement would oust them of jurisdiction. C. Edward Fletcher, Arbitrating Securities Disputes 15 (1990).
eral court and sought to put such agreements on the "same footing as other contracts."92

The FAA provides that an agreement to arbitrate a future controversy contained in any maritime transaction or a "contract evidencing a transaction involving commerce"93 shall be "valid, irrevocable and enforceable, save upon such grounds as exist at law or in equity for the revocation of any such contract."94 It further provides procedures for the enforcement of such agreements. The FAA empowers a court, upon application, to stay any pending action if the issue therein is referable to arbitration95 and to compel arbitration in the event a recalcitrant party to an arbitration agreement refuses to submit the controversy to arbitration.96 The court is also given the authority to confirm97 or vacate98 an award. Vacator of an award is permitted under very limited circumstances.99 Significantly, the FAA does not

93. 9 U.S.C. § 2 (1994). The term commerce is defined as:
[Commerce among the several States or with foreign nations, or in any Territory of the United States or in the District of Columbia, or between any such Territory and another, or between any such Territory and any State or foreign nation, or between the District of Columbia and any State or Territory or foreign nation, but nothing herein contained shall apply to contracts of employment of seamen, railroad employees, or any other class of workers engaged in foreign or interstate commerce. 9 U.S.C. § 1 (1994).

The Supreme Court recently considered the issue of the meaning of the phrase "contract evidencing a transaction involving commerce" in Allied Bruce Terminix Co. v. Dobson, 115 S. Ct. 834, 836 (1995). There, the Court determined that the phrase should be read broadly, extending the FAA's reach to the limits of Congress' commerce powers rather than restricting its meaning to those transactions contemplated by the parties to involve interstate commerce. Id. Accordingly, the Court upheld arbitration of a consumer dispute despite state law to the contrary. Id.

Even prior to Dobson, almost all securities transactions were found to involve interstate commerce. Fletcher, supra note 91, at 46. Courts had held that a purchase or sale of a security on a national securities exchange constituted a transaction involving commerce as did an agreement between a brokerage firm and an investor. Id. at 47; see also Grant, supra note 6, at 416-17 (stating that securities transactions that utilize the medium of the national securities exchanges or the facilities of the mails, telephone and telegraph clearly fall within the FAA).

99. An award may be vacated:

(1) where the award was procured by corruption, fraud or undue means.
(2) where there was evident partiality or corruption in the arbitrators, or either of them.
(3) where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced.
create new rights,\textsuperscript{100} nor does it require that parties arbitrate disputes.\textsuperscript{101} Instead, it merely provides a remedy to enforce an agreement to arbitrate.\textsuperscript{102} Although the FAA was enacted in 1925, the supremacy of the FAA over state law and the controlling substantive law was made explicit only in a series of cases in the last fifteen years.

In the landmark case of \textit{Moses H. Cone Memorial Hospital v. Mercury Construction Corp.},\textsuperscript{103} the Supreme Court held that the FAA creates a body of federal substantive law evidencing a strong federal policy favoring arbitration which is applicable in both state and federal court.\textsuperscript{104} There, the Court indicated that any doubts concerning the arbitrability of an issue should be resolved in favor of arbitration.\textsuperscript{105} In often cited language, the Court stated:

\begin{quote}
Federal law in the terms of the Arbitration Act governs [the issue of whether the suit was arbitrable] in either state or federal court . . . Section 2 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. . . . 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.\textsuperscript{106}
\end{quote}

One year later, the Court demonstrated the consequence of its holding in \textit{Moses H. Cone Memorial Hospital} regarding the supremacy

\begin{footnotesize}

\textsuperscript{4} where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final and definite award upon the subject matter was not made.


\textsuperscript{100} 65 CONG. REC. 1931 (1924).

\textsuperscript{101} See, e.g., Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 219 (1985) (stating that the FAA does not mandate the arbitration of all claims but merely the enforcement of "privately negotiated arbitration agreements").

\textsuperscript{102} 65 CONG. REC. 1931 (1924).

\textsuperscript{103} 460 U.S. 1 (1983).

\textsuperscript{104} Id. at 24. In \textit{Prima Paint Corp. v. Floor & Conklin Manufacturing Corp.}, 388 U.S. 395 (1967), the Court had previously held that in a diversity action, the FAA controlled the issue of whether the arbitrator or the court should decide if a contract containing an arbitration clause was fraudulently induced.

While the FAA creates substantive federal law, it does not create an independent basis for federal subject matter jurisdiction. \textit{Moses H. Cone Memorial Hosp.}, 460 U.S. at 25 n.32.

\textsuperscript{105} Id. at 24-25.

\textsuperscript{106} Id.
\end{footnotesize}
of the FAA.\textsuperscript{107} In \textit{Southland Corp. v. Keating},\textsuperscript{108} the Court held that the FAA gives it the power to create federal substantive law that is applicable in both federal and state court.\textsuperscript{109} Accordingly, federal law preempts conflicting or contrary state law: "In creating a substantive rule applicable in state as well as federal courts, Congress intended to foreclose state legislative attempts to undercut the enforceability of arbitration agreements."\textsuperscript{110} Thus, states are precluded from requiring a judicial forum when parties have previously agreed to arbitrate their dispute.\textsuperscript{111}

The result in \textit{Southland} is not overwhelmingly supported. Indeed, the Supreme Court was asked recently to overrule \textit{Southland} on the basis that the FAA is a procedural, not substantive, statute and, like other federal procedural statutes, is applicable only in federal court.\textsuperscript{112} The Court declined and thereby reinforced the supremacy of the

\textsuperscript{107} The consequence was not apparent in \textit{Moses H. Cone Memorial Hosp.} inasmuch as that case was brought in federal, not state, court. \textit{Southland Corp. v. Keating}, 465 U.S. 1, 35 (1984) (O'Connor, J., dissenting).

\textsuperscript{108} 465 U.S. 1 (1984). There, 7-Eleven franchisees sued the franchisor in California state court for, \textit{inter alia}, fraud, breach of contract and violations of the California Franchise Investment Law. \textit{Id.} at 4. The agreement between the parties required arbitration of the disputes, but the California Franchise Investment Law prohibited arbitration of claims made pursuant to it. \textit{Id.}

\textsuperscript{109} \textit{Id.} at 12.

\textsuperscript{110} \textit{Id.} at 16. The Court in \textit{Southland} found that the FAA preempted the California Franchise Investment Law. \textit{Id.; accord Doctor's Assocs., Inc. v. Casarotto}, 116 S. Ct. 1652, 1656 (1996) (stating that the FAA preempted Montana law that required special disclosure of a predispute arbitration clause as a condition to the enforceability of the agreement to arbitrate); \textit{Perry v. Thomas}, 482 U.S. 483, 491 (1987) (finding that the FAA preempted California law which authorized former employee of securities brokerage firm to bring an action in court for wages despite the existence of an agreement to arbitrate).

\textsuperscript{111} The Court reached this conclusion, in part, because of its concern that forum shopping would develop if the rule were otherwise. \textit{Southland}, 465 U.S. at 15.

\textsuperscript{112} \textit{Allied-Bruce Terminix Co. v. Dobson}, 115 S. Ct. 834, 838-39 (1995). Respondent and twenty state attorneys general requested that \textit{Southland} be overruled so that Alabama could apply its own arbitration statute which prohibited arbitration of consumer claims. \textit{Id.} at 839. The Court declined to do so on the basis that nothing had changed in the ten years subsequent to \textit{Southland} to erode its authority, no unforeseen practical problems had arisen due to its application, private parties had likely relied on it in drafting their arbitration agreements and Congress had enacted legislation expanding, not restricting, the scope of arbitration under the FAA. \textit{Id.} Justices Scalia and Thomas dissented and advocated that \textit{Southland} be overruled. \textit{Id.} at 844-51 (Scalia, J., and Thomas, J., dissenting).

Respondent's argument was reminiscent of the one advanced by Justice O'Connor in her dissent (joined by Justice Rehnquist) in \textit{Southland}. There, she stated that the majority decision to require that state courts apply the FAA was "unquestionably wrong as a matter of statutory construction." \textit{Southland Corp.}, 465 U.S. at 24 (1984) (O'Connor, J., dissenting). Although Justice O'Connor concurred with the decision in \textit{Dobson} not to overrule \textit{Southland}, she did so on the basis of \textit{stare decisis}. \textit{Dobson}, 115 S. Ct. at 844 (O'Connor, J., concurring). She continued to maintain, however, that \textit{Southland} was wrongly decided, but acknowledged that it was not unworkable and that Congress had not chosen to overrule it. \textit{Id.}
The Court’s willingness to strengthen the role of the FAA and give effect to Congress’ directive to enforce agreements to arbitrate, as demonstrated in *Moses H. Cone Memorial Hospital* and *Southland*, strongly influenced the Court’s decision to endorse SRO arbitration.

**B. History of the FAA’s Impact on Securities Arbitration**

1. *Wilko v. Swan*

*Wilko v. Swan* has been characterized as “mark[ing] the beginning of the modern era of securities arbitration” and is the first reported case addressing the arbitrability of claims alleging violations of the federal securities laws. There, the Court attempted to reconcile the policy considerations behind the FAA with the policy considerations behind the Securities Act. In *Wilko*, the Securities Act won the upper hand, but its victory was shortlived; the Court overruled *Wilko* thirty-five years later in *Rodriguez de Quijas v. Shearson/American Express, Inc.*

In *Wilko*, an investor signed a margin agreement which contained a clause requiring arbitration of any controversy under the rules of the Arbitration Committee of the Chamber of Commerce, the AAA or the NYSE. A dispute arose concerning representations about a merger made in connection with a stock purchase. The investor, rather than arbitrating the matter, brought an action in federal district court for violations of section 12(2) of the Securities Act, which,

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113. *Id.* at 843.

114. The converse, “History of Securities Arbitration’s Impact on the FAA,” is equally valid. Much of the law pursuant to the FAA has been developed and continues to be developed in the context of securities arbitration clauses. See, e.g., *First Options of Chicago, Inc. v. Kaplan*, 115 S. Ct. 1920 (1995) (indicating that the contract between parties determines who will decide the issue of arbitrability); *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 115 S. Ct. 1212 (1995) (noting that the securities arbitrator has power to award punitive damages).


117. *Id.* at 35.

118. *Id.* The Securities Act, enacted a mere eight years after the FAA, does not address the issue of whether parties can agree to arbitrate controversies arising under it. 15 U.S.C. §§ 78a-78u (1994).

119. 490 U.S. 477 (1989); see also infra notes 204-09 and accompanying text (discussing the opinion in *Rodriquez de Quijas v. Shearson/American Express, Inc.*).


122. *Id.* at 429.
among other things, permits the plaintiff to sue in either state or federal court.\textsuperscript{123} The issue before the Court was "whether an agreement to arbitrate a future controversy is a 'condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision' of the Securities Act which section 14 [of the Act] declares 'void.'"\textsuperscript{124} The Supreme Court held that the agreement to arbitrate was such a stipulation waiving the right to select the judicial forum pursuant to section 12(2).\textsuperscript{125} Because the Securities Act gives the investor a wider choice of venue and courts, the investor, by agreeing to arbitrate, gives up more than an ordinary participant in a commercial transaction.\textsuperscript{126} The Court came to this conclusion despite the broad language in the FAA that agreements to arbitrate future disputes are valid and enforceable.\textsuperscript{127}

The Court, while recognizing that the provisions of the Securities Act would apply in an arbitration, questioned the effectiveness of their application in arbitration.\textsuperscript{128} The Court distinguished the typical commercial arbitration, where the "quality of a commodity or the amount of money due under a contract" was at issue, from the arbitration of a securities dispute where the "subjective findings of the purpose and knowledge of an alleged violator of the Act" must be determined.\textsuperscript{129} The Court was further concerned with its ability to ensure that the provisions of the Securities Act were followed inasmuch as arbitration decisions are made without judicial instruction on the law in proceedings where no record is kept and by arbitrators whose determinations, without explanation, are not easily vacated.\textsuperscript{130}

The dissent was much less suspicious of arbitration than was the majority and much more willing to see the advantages of arbitra-

\textsuperscript{123} 15 U.S.C. § 77i(2) (1994). The Supreme Court characterized section 12(2) as creating a special right to recover for misrepresentation, different than that which existed at common law. \textit{Wilko}, 346 U.S. at 431. Unlike the common law, section 12(2) places the burden of proving lack of scienter on the seller of the securities, it permits the claim to be enforced in any state or federal court, and if suit is brought in federal court, it gives the plaintiff a wide choice of venue, the privilege of nationwide service of process and it dispenses with the jurisdictional dollar amount requirement for diversity cases. \textit{Id.}

\textsuperscript{124} \textit{Id.} at 430. Section 14 of the Securities Act provides: "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void." 15 U.S.C. § 77n (1994).

\textsuperscript{125} \textit{Wilko}, 346 U.S. at 434-35.

\textsuperscript{126} \textit{Id.} at 435.

\textsuperscript{127} \textit{Id.} at 437.

\textsuperscript{128} \textit{Id.} at 435-36.

\textsuperscript{129} \textit{Id.}

\textsuperscript{130} \textit{Id.} at 436.
Justices Frankfurter and Minton objected to the Court denying a litigant the advantages of arbitration, which "provid[es] a speedier, more economical and effective enforcement of rights," absent a showing that the arbitral system "would not afford the [customer] the rights to which he is entitled" or that the customer had "no choice" but to accept the arbitration stipulation, thereby rendering it an "unconscionable and unenforceable provision in a business transaction." As will be discussed, the dissent's position ultimately prevailed.

Following Wilko, lower courts extended its prohibition to claims brought pursuant to section 10(b) of the Exchange Act. The Supreme Court questioned the extension of Wilko to such claims before it questioned Wilko itself. However, in the interim, the Court decided a number of cases, both inside and outside of the securities law context, that demonstrated both a willingness to permit arbitration of statutory claims, at least in the international context, and a willingness to put teeth into Congress' directive that arbitration agreements be treated and enforced like any other contract.

131. Id. at 439 (Frankfurter, J., dissenting).
132. Id. at 439-40. The dissent specifically discussed the fact that under the rules of the AAA, the parties could choose their arbitrators so that "those who are charged to enforce the rights are selected by the parties themselves from among those qualified to decide." Id. at 439.
133. Id. at 440.
134. See infra notes 206-09 and accompanying text (discussing the opinion in Rodriguez de Quijas v. Shearson/American Express, Inc.).

Until the Supreme Court's decision in Dean Witter Reynolds Inc. v. Byrd, 470 U.S. 213 (1985), where the Court declined to address the issue of the extension of Wilko to Exchange Act claims, there was uniformity among the circuits that Wilko applied to section 10(b) claims under the Exchange Act. Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 248-49 (1987) (Blackmun, J., dissenting). After Byrd, some courts, relying on the concurrence in Byrd, declined to extend Wilko and found section 10(b) claims arbitrable. McMahon, 482 U.S. at 249 n.8.


136. See supra notes 90-92 and accompanying text (discussing the enactment of the FAA).
2. Scherk v. Alberto-Culver Co.\textsuperscript{137}

In this 5-4 decision, the Supreme Court declined to extend \textit{Wilko} to bar arbitration of a section 10(b) claim under the Exchange Act when the arbitration clause was contained in an agreement evidencing an international transaction.\textsuperscript{138} In justification, the Court did not rely on any differences between the Exchange Act and the Securities Act, although it recognized that a "colorable argument" could be made that such differences in the language and provisions of the two Acts may require a contrary result.\textsuperscript{139} Rather, the Court relied on the difference between the transaction at issue in \textit{Scherk} and the transaction at issue in \textit{Wilko}. The Court stressed the international nature of the transaction in \textit{Scherk} and found that difference to be "significant" and "crucial," which raised concerns that did not exist in \textit{Wilko}.\textsuperscript{140} For example, in \textit{Wilko}, there was no question that the law of the United States would govern;\textsuperscript{141} in \textit{Scherk}, there was considerable uncertainty as to what law would apply.\textsuperscript{142} That uncertainty made the predispute arbitration clause an "almost indispensable precondition to achievement of the orderliness and predictability essential to any international business transaction."\textsuperscript{143} Thus, because the agreement

\begin{footnotesize}
\textsuperscript{137} 417 U.S. 506 (1974).
\textsuperscript{138} \textit{Id.}
\textsuperscript{139} Id.
\textsuperscript{140} \textit{Wilko} v. Swan, 346 U.S. 427, 430 (1953).
\textsuperscript{141} \textit{Scherk}, 417 U.S. at 515.
\textsuperscript{143} \textit{Id.} at 516.
\end{footnotesize}
containing the arbitration clause concerned the purchase of an international business, the provisions of the FAA could not be "ignored" and, consequently, Alberto-Culver could not "repudiate its solemn promise" to arbitrate.

3. Dean Witter Reynolds, Inc. v. Byrd

The Court’s desire to enforce the requirements of the FAA, as demonstrated in Moses H. Cone Memorial Hospital and Southland, had the paradoxical effect of causing a result in Byrd that actually promoted inefficiency. An investor brought an action in federal court alleging violations of the Exchange Act and violations of various state law provisions. The investor had signed a Customer Agreement when he first opened his account which contained an arbitration clause.

The issue was whether a federal court could try both arbitrable and nonarbitrable claims together if they were sufficiently factually and legally "intertwined" or whether the court must bifurcate the claims. The Court held that bifurcation was mandated by the FAA, "even where the result would be the possibly inefficient maintenance..."

opposing party may by speedy resort to a foreign court block or hinder access to the American court of the purchaser’s choice.” Id. at 518.

144. Id. at 513.
145. Id. at 519.
146. The dissent in Scherk, like the majority in Wilko, relied upon the antiwaiver provisions of the Exchange Act to find the agreement to arbitrate void. Id. at 524 (Douglas, J., dissenting). The international nature of the transaction did not require a different result insofar as the Exchange Act’s antiwaiver provision makes no distinction between domestic and international agreements. Id. The dissent also reiterated the deficiencies with arbitration, as set forth in the Wilko opinion, which presumably would also apply to the arbitration of a dispute arising under a contract evidencing an international transaction. Id. at 532.
148. See supra notes 103-06 and accompanying text (discussing the strong federal policy in favor of arbitration).
149. See supra notes 108-11 and accompanying text (discussing the federal preemption of state law in arbitration).
151. Id. at 215.
152. Id. at 215-16. Dean Witter apparently assumed that the Exchange Act claims were not arbitrable under Wilko, and the majority in Byrd declined to address that issue because it was not properly before the Court. Id. at 216 n.1.
153. The lower courts that relied on the doctrine of intertwining to try both arbitrable and nonarbitrable claims together did so because it was believed necessary to preserve their exclusive jurisdiction over the federal claims in the event the arbitration concluded first and the award had preclusive effect and because it was more efficient by avoiding relitigation of the same issues. Id. at 217.
154. The lower courts that required bifurcation did so on the basis that the FAA divested them of any authority over arbitrable claims. Id. at 218-19.
of separate proceedings in different forums.” 155 In so holding, the Court rejected the suggestion that the primary goal of the FAA was to promote the expeditious resolution of claims. 156 Rather, the foremost purpose behind the passage of the FAA was to ensure judicial enforcement of privately made agreements to arbitrate: “The Act, after all, does not mandate the arbitration of all claims, but merely the enforcement . . . of privately negotiated arbitration agreements.” 157

Justice White concurred. 158 While acknowledging that the issue of the arbitrability of claims under the Exchange Act was not properly before the Court, Justice White nevertheless stated that the extension of Wilko to the Exchange Act was “a matter of substantial doubt.” 159 He noted that the jurisdiction under the Exchange Act is more narrow than that under the Securities Act and that the cause of action in Wilko was express while the claim before the Court was implied under section 10(b) of the Exchange Act. 160 While Justice White’s view ultimately prevailed, it was not for the reasons upon which he relied. 161 His concurrence, however, had the effect of calling into question the whole line of lower court decisions extending Wilko to Exchange Act claims. 162 Thus, while the Byrd decision caused controversy, it was not because of the majority’s rigorous enforcement of the agreement to arbitrate, but because of the dicta contained in Justice White’s concurring opinion.

4. Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc. 163

The decision in Mitsubishi was probably the best indication of how the Supreme Court would rule when it squarely addressed the issue of the arbitrability of claims brought pursuant to the Exchange Act. Like the arbitration clause in Scherk, the arbitration clause in Mitsubishi was contained in an agreement embodying an international transaction concerning the sale and distribution of automobiles. 164 After a dispute arose between the parties, Mitsubishi brought an action

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155. Id. at 217.
156. Id. at 219-21.
157. Id. at 219.
158. Id. at 224 (White, J., concurring).
159. Id. Justice White’s concurrence echoes the Scherk Court’s “colorable argument” dicta.
160. Id. at 224-25.
161. See infra notes 204-09 and accompanying text (discussing the opinion in Rodriguez de Quijas v. Shearson/Am. Express, Inc.).
164. Id. at 617.
against Soler in a United States federal court under the FAA and the Convention on the Recognition and Enforcement of Foreign Arbitral Awards seeking an order compelling arbitration in accordance with the parties' agreement to arbitrate all disputes in accordance with the rules and regulations of the Japan Commercial Arbitration Association. Soler counterclaimed against Mitsubishi for, among other things, violations of the Sherman Act.

The Court first addressed the issue of whether an American court could enforce an agreement to arbitrate when antitrust claims are raised. The Court disagreed with Soler's contention that the arbitration clause, which did not expressly state that Sherman Act claims were within its coverage, could not, as a matter of law, be interpreted to encompass statutory claims. The Court found no support in the FAA for a presumption against the inclusion of statutory claims in agreements to arbitrate.

The Court then found that the arbitration agreement between the parties did, in fact, include Soler's claim of violations of the Sherman Act. The Court came to this conclusion by examining the intention of the parties, which, according to Moses H. Cone Memorial Hospital, must be generously construed in favor of arbitration. The Court declined to depart from Moses H. Cone Memorial Hospital solely because claims founded on statutory rights were raised: "[W]e 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 a means of dispute resolution." Thus, in construing an agreement to arbitrate, a court should not pause as to the origin of the claims being asserted. Absent claims that the agreement to arbitrate was procured by fraud or overwhelming economic power, the "[FAA] itself provides no basis for disfavoring agreements to arbitrate statutory claims by skewing the otherwise hospitable inquiry into arbitrability."

165. Id. at 618.
166. Id. at 619.
167. Id. at 626-27.
168. Id. at 625.
169. Id. at 629.
170. Id. at 625.
171. See supra note 106 and accompanying text (holding that any doubt concerning the scope of arbitral issues should be resolved in favor of arbitration).
172. Mitsubishi Motors Corp., 473 U.S. at 626.
173. Id. at 626-27.
174. Id.
In support of its determination that the parties intended to arbitrate the Sherman Act claims, the Court stressed that, by so agreeing, a party does not give up the substantive rights granted by the Sherman Act. Instead, all the party does is trade the "procedures and opportunity for review" of litigation in a judicial forum for the "simplicity, informality and expedition of arbitration." 

The decision in *Mitsubishi* undoubtedly provided the foundation needed by the Court to find Exchange Act claims arbitrable. The *Mitsubishi* Court endorsed arbitration as an adequate method for the resolution of disputes, and it put statutory claims on the same footing as common law claims, at least in the context of an international agreement to arbitrate.

5. *Shearson/American Express, Inc. v. McMahon*  

The *McMahon* decision is an important one both for the arbitration of securities law claims and for arbitration generally. By enforcing the predispute arbitration clause and permitting the arbitration of Exchange Act and RICO claims, "securities arbitration was basically transformed from a voluntary procedure to a mandatory obligation" and the continued suspicion of arbitration was further undermined and denounced.

The McMahons, customers of Shearson, filed suit in federal court alleging violations of the antifraud provisions of the Exchange Act section 10(b) and Rule 10b-5, claims based on RICO, and various state law claims. Because the McMahons had signed a Customer

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175. *Id.* at 628. The Court's recognition that arbitration does not result in the loss of substantive rights is particularly significant with respect to the analysis of the eligibility rule. See infra notes 356-413 and accompanying text.

176. *Mitsubishi Motors Corp.*, 473 U.S. at 628. After determining that the parties intended to include Sherman Act claims within the arbitration provision, the Court next considered whether, notwithstanding that agreement, the Sherman Act claims should not be arbitrated. In addressing this issue, the Court, as it did in *Scherk*, discussed only the appropriateness of arbitration of the Sherman Act claims in the international context. The Court found *Scherk* controlling and concluded that, based on concerns of international comity and the need for predictability in the international commercial system, the agreement to arbitrate should be enforced. *Id.* at 629-30.


178. The *McMahon* decision has been the subject of extensive commentary. See Shell, * supra* note 36, at 397 n.3 (listing a number of citations to *McMahon* commentary); see also Hermann, * supra* note 6, at 699 n.22 (same).

179. *NYSE Symposium, supra* note 12, at 1507 (panelist Professor Katsoris); see also Lewis D. Lowenfels & Alan R. Bromberg, *Securities Industry Arbitrations: An Examination and Analysis*, 53 ALB. L. REV. 755, 757 (1989) (stating that, in practical effect, *McMahon* and *Rodriguez de Quijas* established that most disputes in the securities industry will be resolved not in courts, but through arbitration).


181. *Id.* at 223.
Agreement which provided for arbitration of any controversy before an SRO-administered arbitral forum. The court of appeals, relying on Wilko, although noting that Scherk and Byrd had cast doubt on its applicability to Exchange Act claims, denied the motion with respect to the Exchange Act and RICO claims.

In reversing, the Supreme Court first discussed the federal policy favoring arbitration and, relying on Mitsubishi, indicated that its duty to enforce agreements to arbitrate was not diminished when the claim sought to be arbitrated involved a violation of a federal statute. After finding that the FAA itself required enforcement of an agreement to arbitrate statutory claims, the Court next discussed whether Congress had overridden the FAA’s directive in the Exchange Act or in RICO.

The McMahons argued that the antiwaiver provision in the Exchange Act, like the antiwaiver provision in the Securities Act, demonstrated a congressional intent that Exchange Act violations should not be arbitrated but rather should have a judicial forum. This time, the Court was not convinced. The Court, in distinguishing Wilko, relied not on the purported differences between the antiwaiver provisions of the two Acts but on what the Court characterized as the Wilko Court’s “general suspicion of the desirability of arbitration and the competence of arbitral tribunals.” Because the reasons given by Wilko for questioning the adequacy of the arbitral forum had been subsequently rejected by the Court, Wilko did not control and could no longer be squared with the law as it had developed with respect to arbitration generally.

Indeed, the Court rebuked each reason given by the Wilko Court for distrusting the adequacy of the arbitral forum in handling Securities Act claims. The concern that difficult and subjective determi-
nations would be required of arbitrators without judicial reasoning was rejected in *Mitsubishi*, where the Court recognized that arbitrators were "readily capable of handling the factual and legal complexities of antitrust claims." The streamlined procedures of arbitration were not found to entail any "consequential restrictions on substantive rights," and the Court had also refused to assume that arbitrators would not follow the law.

In further support of the Court's finding that the *Wilko* Court's suspicion of arbitration was no longer valid, the Court relied on the fact that the SEC, pursuant to amendments to the Exchange Act en-

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191. *Id.* at 232.
192. *Id.*
193. *Id.* The Court stated that the limited judicial review of arbitration awards was sufficient to ensure that arbitrators follow the law. *Id.; see supra* note 99 (noting when an award may be vacated).

The SEC dramatically changed its position when it endorsed arbitration of Exchange Act claims in *McMahon*. See Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 261-62 (1987) (Blackmun, J., dissenting). There, the SEC alleged that its previous position against arbitration was due solely to the *Wilko* decision and credited its authority over SRO rules as one of the reasons for its change of heart. The dissent quite persuasively questioned the genuineness of the SEC's purported change of heart. The dissent pointed out that the SEC, even before *Wilko*, had consistently taken the position against the arbitrability of federal securities law claims, and that it had also maintained that its regulatory authority over SRO rules could not ensure the adequacy of SRO arbitration. *Id.* at 262 (Blackmun, J., dissenting).

The SEC's change in position may have been political (the Reagan administration's general policy of deregulation, the congressional endorsement of arbitration in the Commodity Exchange Act), practical (the growing realization by the SEC that arbitration has advantages for investors) or expedient (the SEC may have anticipated the result and preferred not to lose another battle with the Court). Lowenfels & Bromberg, supra note 179, at 764. Whatever the reason, the SEC's endorsement of SRO arbitration for Exchange Act claims undoubtedly played a role in the Court's decision. After the *McMahon* decision, the SEC rescinded Rule 15c2-2. Rescission of Rule Governing Use of Predispute Arbitration Clauses in Broker-Dealer Customer Agreements, Exchange Act Release 25034 [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,163 (Oct. 21, 1987).

In the much awaited decision in *Mastrobuono* v. Shearson Lehman Hutton, Inc., 115 S. Ct. 1212 (1995), regarding the availability of punitive damages in SRO arbitration, the SEC's position seemed to have played an essential role in the Court's decision. The *Mastrobuono* Court, finding that arbitrators could indeed award punitive damages, did not rely on the reasoning or arguments advanced by either party in the action, but rather upon the reasoning set forth by the SEC. *Id.* at 1218. The Court's reliance on the SEC demonstrates that it "helps to have powerful
acted after *Wilko*,\(^{195}\) gained authority over the rules of the SROs. That authority, the Court found, gave the SEC “expansive power to ensure the adequacy of the arbitration procedures employed by the SROs,”\(^{196}\) and because the SEC had approved the procedures of the three SRO forums listed in the Customer Agreement, the Court held that an arbitration agreement “does not effect a waiver of the protections of the Act.”\(^{197}\) Thus, in the process of enforcing the predispute agreement to arbitrate Exchange Act claims, the *McMahon* Court also legitimized SRO arbitration.\(^{198}\)

The dissent\(^{199}\) took issue with the majority’s uncritical acceptance of arbitration and its disregard of the problems identified with it by the *Wilko* Court.\(^{200}\) While acknowledging that there had been an improvement in the procedures applicable in securities arbitrations,\(^{201}\) the dissent did not believe that such improvements changed arbitration so significantly as to eliminate the *Wilko* Court’s concerns with

\[^{195}\text{See supra note 66 and accompanying text (noting that Congress amended the Exchange Act to grant the SEC the power to amend the rules of the SROs). The dissent pointed out that Congress in those amendments did not attempt to overrule Wilko. *McMahon*, 482 U.S. at 247 (Blackmun, J., concurring and dissenting).}\]

\[^{196}\text{*McMahon*, 482 U.S. at 233.}\]

\[^{197}\text{Id. at 234. Although it is not entirely free from doubt, the tenor of the opinion suggests that the Court would have come to the same conclusion even if the SEC did not have regulatory control over the rules of the SROs. The SEC’s additional regulatory authority seems to have been a justification for avoiding the doctrine of *stare decisis*: “While *stare decisis* concerns may counsel against upsetting *Wilko*’s contrary conclusion under the Securities Act, we refuse to extend *Wilko*’s reasoning to the Exchange Act in light of these intervening regulatory developments.” *Id.*}\]

\[^{198}\text{The Court’s endorsement of the adequacy of SRO arbitration also led it to find that the RICO claims were arbitrable. *Id.* at 240. Because there was nothing in the text or the legislative history of RICO indicating congressional intent to exempt claims based on RICO from the requirements of the FAA, the Court considered whether arbitration of RICO claims irreconcilably conflicted with the principles underlying RICO. *Id.* The Court found no conflict inasmuch as the investors “effectively may vindicate [their RICO claims] in the arbitral forum.” *Id.*}\]

\[^{199}\text{Id. at 242 (Blackmun, J., concurring and dissenting). Justices Blackmun, Brennan and Marshall dissented as to the arbitrability of the Exchange Act claims. Justice Stevens, writing separately, also dissented on the same basis. He asserted that the longlasting interpretation of *Wilko*’s applicability to Exchange Act claims created a strong presumption that any mistake that the Court may have made in interpreting the statute should be remedied not by the judiciary, but by Congress. *Id.* at 268-69 (Stevens, J., concurring and dissenting).}\]

\[^{200}\text{Shearson/Am. Express, Inc., v. *McMahon*, 482 U.S. 220, 250 (1987) (Blackmun, J., concurring and dissenting). The dissent was also not convinced that the SEC’s oversight of SRO rules was enough to ensure that SRO arbitration was adequate inasmuch as the SEC’s authority extended only to a general review of SRO rules and did not include the authority to police or monitor the results of arbitration for the misapplication of the law or for the fairness of the proceedings. *Id.* at 265.}\]

\[^{201}\text{The dissent specifically noted the development of the UCA. *Id.* at 257-58.}\]
it. Ultimately, the dissent concluded that a congressional policy was needed to alter the special position the customer was granted in the Exchange Act.


Although the McMahon dissent asserted that the majority's decision effectively overruled Wilko, it was not officially overruled until two years later in Rodriguez de Quijas. In the 5-4 decision, the Court found that, once it put aside "the outmoded presumption of disfavoring arbitration proceedings," the special rights granted by the Securities Act with respect to choice of forum and wider venue selection could indeed be dispensed with by an arbitration agreement without contravening the Securities Act. The special rights described in Wilko were characterized as "procedural" and, as such, were not covered by the antiwaiver provision of the Securities Act.

Thus, the Court further endorsed arbitration for the resolution of securities law disputes and continued to effectuate the objective of the FAA. With the overruling of Wilko, there were no longer any restrictions, except those restrictions provided in the FAA itself, to the arbitration of securities law claims.

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202. Id. at 259. The dissent gave a few examples of the problems with SRO arbitration that still existed: the lack of a record of proceedings; the fact that arbitrators were not bound by precedent and were discouraged from giving reasons for their decisions; and the very limited judicial review of such decisions. Id.

203. Id. at 260. The dissent expressed particular concern with the position that the investor is relegated to in the arbitral forum. It noted that securities arbitrations take place in forums controlled by the securities industry, which gives the broker-dealer a decided advantage over the investor. Id. at 260-61.


206. Rodriguez de Quijas v. Shearson/Am. Express, 490 U.S. 477, 481 (1989). The Court cited McMahon, Scherk, Mitsubishi, Byrd and Moses H. Cone Memorial Hospital as evidence of the erosion of the hostile judicial attitude against arbitration that pervaded the Wilko decision. Id. at 480-81.

207. Id. at 481-82.

208. Id. at 482. The Court stated: "To 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." Id. at 481.

209. The FAA provides that a predispute arbitration agreement "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2 (1994). Indeed, the Rodriguez de Quijas Court indicated that if the party opposing arbitration presents well-supported allegations that the arbitration agreement resulted from fraud or overwhelming economic power, then grounds for the revocation of the agreement would exist under the FAA. Rodriguez de Quijas, 490 U.S. at 483-84 (citing Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 627 (1985)).
IV. The Eligibility Rule

The Supreme Court's endorsement of SRO arbitration was based on the presumption that SRO arbitration does not result in the loss of substantive rights.\textsuperscript{210} An agreement to arbitrate was characterized as a "specialized kind of forum-selection clause,"\textsuperscript{211} where the party does not forgo substantive rights, but merely "trades the procedures and opportunity for review of the courtroom for the simplicity, informality and expedition of arbitration."\textsuperscript{212} The Court came to that conclusion, however, without examining the specific procedures applicable in SRO arbitral forums.\textsuperscript{213}

The eligibility rule, applicable in SRO arbitration, seemingly contrary to the foregoing federal law, results in the loss of a substantive right.\textsuperscript{214} The rule has been interpreted by the securities industry and by the judiciary to bar an investor from bringing, in either an arbitral or judicial forum, a claim, otherwise timely pursuant to the statute of limitations when, pursuant to the eligibility rule, six years have elapsed from the occurrence or event giving rise to the claim.\textsuperscript{215} If the securities industry and the lower federal courts are correct in this view, then the enforceability of predispute arbitration clauses requiring arbitration before an SRO forum must be revisited, for such a result has the effect of forcing investors to unknowingly relinquish an

\begin{itemize}
  \item \textsuperscript{210} \textit{Rodriguez de Quijas}, 490 U.S. at 481; Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 229 (1987). A member of the securities industry recollected as follows:
    
    The way arbitration was sold to both the Supreme Court and the SEC was that essentially you have the same rights in arbitration as you would have in court. We're not going to use arbitration to limit the right to recoup damages. We're not going to use arbitration to limit statutes of limitations.

  \item \textit{NYSE Symposium, supra} note 12, at 1523 (panelist Mr. Page).

  \item \textit{Rodriguez de Quijas}, 490 U.S. at 483 (quoting Scherk v. Alberto-Culver Co., 417 U.S. 506, 519 (1974)).

  \item \textit{Mitsubishi Motors Corp.}, 473 U.S. at 628. It is questionable today whether an investor who agrees to arbitrate is actually getting the benefit of the bargain. Criticism is mounting that securities arbitration is no longer informal or expeditious. \textit{See, e.g., Task Force Report, supra} note 43, at 87,433 ("[t]he increasingly litigious nature of securities arbitration has gradually eroded the advantages of SRO arbitration."); Stewart, \textit{supra} note 194, at 5; Susan Antilla, \textit{Wall Street, The Next Magic Bullet? Mediation}, N.Y. TIMES, Feb. 5, 1995, \S 3, at 3; Bill Barnhart, \textit{Few Satisfied with Securities Arbitration, Chi. TRIB.}, Aug. 22, 1994, \S 3 (Business); Jay Matthews, \textit{Arbitration Cases Grow in Number and Complexity}, WASH. POST, Jan. 9, 1994, at H01.

  \item The Supreme Court has consistently maintained that while the FAA requires the enforcement of agreements to arbitrate it does not prescribe the procedures that are to govern in the arbitral forum. \textit{See, e.g., Volt Info. Sys. v. Board of Trustees, 489 U.S. 468, 469 (1988)} ("There is no federal policy favoring arbitration under a certain set of procedural rules; the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate.").

  \item \textit{See infra} part IV.B.2.

  \item \textit{See infra} notes 356-413 and accompanying text (discussing the loss of substantive rights in the analysis of the eligibility rule).
\end{itemize}
essential substantive right. Investors trade-off many of the procedural protections of the judicial forum for the expedition and informality of arbitration. That trade-off should not include the right to bring the timely claim itself.

A. The Eligibility Rule and Its Origins

The NASD Eligibility Rule provides as follows:

Time Limitation on Submission
Sec. 15.
No dispute, claim, or controversy shall be eligible for submission to arbitration under this Code where six (6) years have elapsed from the occurrence or event giving rise to the act or dispute, claim, or controversy. This section shall not extend applicable statutes of limitations, nor shall it apply to any case which is directed to arbitration by a court of competent jurisdiction.

The rule was adopted almost verbatim from the UCA's eligibility rule, as amended in 1984. According to Professor Katsoris, an original public member of SICA, the rule was included in the UCA as a matter of convenience to prevent stale claims from going to arbitration. Six years was chosen as the period because it "dovetailed" the SEC's books and record-keeping retention requirement.

The requirements of the rule are clear. A claim may be submitted for arbitration as long as six years have not elapsed from the date of the occurrence or event giving rise to the claim, which is usually deemed the date the securities were purchased. The effect of the rule on an investor's claim is also clear. An investor may have a claim that is eligible for arbitration because it was submitted within six years


Although the current NASD six-year eligibility rule was adopted from the UCA, the original NASD Code of Arbitration Procedure contained a two-year time limitation, which was increased to five years in 1977. NASD Code of Arbitration Procedure (Jan. 1977).

218. NYSE Symposium, supra note 12, at 1533; see also Task Force Report, supra note 43, at 87,434.

219. NYSE Symposium, supra note 12, at 1544 (panelist Deborah Masucci). It has been suggested that one of the original reasons for the imposition of the eligibility rule was document availability and that that reason should no longer be a consideration in view of the increased efficiency in document handling by securities firms. Securities firms, by using microfiche, microfilm and computers, are now able to retain and easily access documents they could not have retained in the late 1970s. Id. at 1548 (panelist Mr. Beckley); see also Task Force Report, supra note 43, at 87,445.

from the date of the occurrence or event giving rise to it, but the claim is nonetheless untimely because the statute of limitations applicable to the claim is shorter than the six-year period. Conversely, an investor may have a claim that is timely within the applicable statute of limitations, but is barred from arbitration because it was submitted more than six years from the date of the occurrence or event giving rise to the claim.

While there are few claims that have a statute of limitations actually longer than six years, accrual and discovery rules, held inapplicable to the SRO eligibility rule,221 may extend the time within which to bring the claim.222 For example, a uniform four-year limitation period is applied to a civil RICO claim.223 In the Second Circuit, a RICO claim accrues every time the plaintiff discovered or should have discovered a new injury caused by the predicate RICO violation.224 In New York,225 the six-year statute of limitations applicable to causes of action based on breach of contract and breach of fiduciary duty226 does not begin to accrue until damages occur, i.e., when losses are incurred.227 For a fraud cause of action, the statute of limitations is the longer of six years from the time the cause of action accrued or two years from discovery of the fraud.228 As these examples demonstrate, it is entirely possible for an investor to be in the position of having a claim deemed timely pursuant to a state or federal limitations period, but untimely pursuant to the SRO eligibility rule. Unfortunately, if the investor signed an agreement which contained an arbitration clause, the investor may lose his or her claim entirely.229

This situation is unlikely to develop, however, with respect to claims based on violations of the federal securities laws due to their rather short statutes of limitations and the fact that tolling principles are in-

221. See infra note 285.
222. Id.
224. Bingham v. Zolt, 66 F.3d 553, 559 (2d Cir. 1995), cert. denied, Steinberg v. Bingham, 116 S. Ct. 1418 (1996). Because the Supreme Court has not addressed the issue of when a cause of action accrues under RICO, a split has developed among the circuits. A civil RICO action has been held to accrue upon, inter alia, the commission of the last predicate act, the discovery of the last predicate act, or the plaintiff's discovery of his or her injuries. Id.
226. These are common claims in securities arbitrations. Id. at 6-7.
227. Id. at 10.
228. Id.
229. See infra note 356 and accompanying text (discussing the majority approach to the consequences of a finding of ineligibility).
applicable.\textsuperscript{230} For example, a claim based on a violation of an implied cause of action pursuant to section 10(b) and Rule 10b-5 of the Exchange Act must be commenced within one year after discovery of the facts constituting the violation and within three years after such violation.\textsuperscript{231} The same holds true for violations of sections 11 and 12(2) of the Securities Act.\textsuperscript{232} The fact that an investor is not likely to be in the position of relinquishing a timely federal securities claim because of the SRO eligibility rule and is more likely to be in that position with respect to other federal claims or state common law claims should not immunize the eligibility rule from review for its fairness and legality. Although the Supreme Court was discussing rights derived from federal statutory law when it held that arbitration does not result in the loss of substantive rights, there is no principled reason to limit that statement to exclude rights derived from state common law. The origin of the rights asserted should be immaterial to the question of whether an investor, by agreeing to arbitrate a future controversy, has unknowingly given up a timely cause of action.\textsuperscript{233}

Although the eligibility rule was part of the original UCA,\textsuperscript{234} the rule did not receive much attention until the early 1990s when arbitration over investments in limited partnership cases became significant.\textsuperscript{235} The monthly statements issued by brokers for customers with investments in limited partnerships typically used the original purchase price as the current value of the partnership.\textsuperscript{236} Thus, any

\textsuperscript{230} The restrictive limitations periods applicable to securities law violations result in many investors forgoing their federal securities claims. Lipner & Deutsch, supra note 225, at 7. Although tolling is not permitted, some courts have applied the doctrine of equitable estoppel to extend the time period applicable for violations of the federal securities laws. Emil Bukhman, \textit{Time Limitations on Arbitrability of Securities Industry Disputes Under the Arbitration Rules of Self-Regulatory Organizations}, 61 Brook. L. Rev. 143, 158-59 (1995) [hereinafter Bukhman, \textit{Time Limitations on Arbitrability}]. See generally Lewis D. Lowenfuss & Alan R. Bromberg, \textit{SEC Rule 10b-5 and Its New Statute of Limitations: The Circuits Defy the Supreme Court}, 51 Bus. Law 309 (1996).


\textsuperscript{233} See Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 621-22 (1985) (citing Southland Corp. v. Keating, 465 U.S. 1, 2 (1984), and construing an arbitration clause to encompass the dispute at issue without pausing at the source in a state statute of the rights asserted by the party).

\textsuperscript{234} Second Report, supra note 73, at A-4.

\textsuperscript{235} Peter Blackman, \textit{Brokerage Firms Seek to Derail Arbitration Effort}, N.Y. L.J. Mar. 3, 1994, at 5.

The NASD, for example, has seen a tremendous increase in the number of motions directed to it based on the eligibility rule. Prior to 1990, the NASD received less than twenty such motions per year. In 1993, that number increased to 600. 470 motions were filed in 1994. These figures do not include the motions that are made directly to court. \textit{NYSE Symposium}, supra note 12, at 1545 (panelist Deborah Masucci).

\textsuperscript{236} Blackman, supra note 235, at 5.
decrease in the value of the investment was not timely disclosed.\textsuperscript{237} In 1991, the North American State Securities Administrators\textsuperscript{238} ruled that this valuing practice used by brokers was fraudulent and mandated that brokers disclose the decrease, if any, in the value of the limited partnership.\textsuperscript{239} When brokers began properly valuing the partnership interests, many customers learned for the first time that their brokers had purchased unsuitable investments for them or had misled them as to the value of their investment.\textsuperscript{240} Lawsuits began and, because many investors had signed predispute arbitration agreements, much of that litigation was submitted to SRO arbitral forums. However, much time had passed between the date of the original investment and the date of the submission of the claim to arbitration. It was in this context that the eligibility rule started to play a role that appears not to have been intended by those who drafted it.\textsuperscript{241}

The fact that brokers are now honestly valuing an investor's interest in a limited partnership does not mean that the role of the eligibility rule will be diminished. Indeed, the eligibility rule may play even a greater role because securities firms are now selling financial products whose value cannot be determined for many years.\textsuperscript{242} Unless the SROs eliminate the eligibility rule or the courts change their interpretation of it, persons investing in these new products may find that by signing the predispute arbitration clause, they have, in essence, agreed not to sue their broker for any misconduct.

B. Interpretation of the Eligibility Rule

Many issues have arisen with respect to the eligibility rule.\textsuperscript{243} This article focuses on two issues in detail: who should determine whether

\textsuperscript{237} Id.

\textsuperscript{238} The NASSA is a group of state securities regulators. Id.

\textsuperscript{239} Id.

\textsuperscript{240} Id.

\textsuperscript{241} See infra notes 114-17 and accompanying text (discussing the original purpose of the eligibility rule and SICA's intent to permit litigation of ineligible claims in a judicial forum).

\textsuperscript{242} \textit{NYSE Symposium, supra} note 12, at 1535 (panelist Seth Lipner) ("There are CMOs based on variable rates and tied to the daily LIBOR that are thirty years out there that cannot be priced."); \textit{see also Task Force Report, supra} note 43, at 87,440 (stating that eligibility rule issues will not abate with the diminution of the numbers of disputes involving limited partnerships).

\textsuperscript{243} The eligibility rule has generated "extensive collateral litigation" which has "contributed to erosion of investor confidence in SRO sponsored arbitration." \textit{Task Force Report, supra} note 43, at 87,434.
a claim is eligible and what the consequence should be to the investor whose claim is found ineligible.\textsuperscript{244}

1. Who Should Decide Whether a Claim Is Eligible Under SRO Rules

The identity of the decision-maker on timeliness issues may have a significant impact on the conclusions reached. It is generally believed that arbitrators, unlike judges, are not bound to follow strictly the law but, rather, may base their decisions on what is “fair, just or sensible under the circumstances.”\textsuperscript{245} Accordingly, one would expect that the party (usually the investor) whose claim is challenged as untimely would fare better if an arbitrator or a panel of arbitrators, and not a judge, determines the eligibility issue.

Until the courts began examining the so-called eligibility rule, the law appeared relatively straightforward that, pursuant to the FAA, the arbitrator and not the court decides whether a claim is time-barred.\textsuperscript{246} This rule was based on the very limited role courts play in determining arbitrability.

In AT&T Technologies, Inc. v. Communications Workers of America,\textsuperscript{247} the Supreme Court held that, because an agreement to arbitrate is a matter of contract and a party may only be compelled to arbitrate an issue he or she has previously agreed to arbitrate, the court, rather than the arbitrator, unless the agreement clearly and unmistakably provides otherwise, should decide if the parties intended to include a particular dispute within the scope of their arbitration agreement.\textsuperscript{248} That is the extent of the court’s role; the court is not

\textsuperscript{244} The question of when the six-year time period begins to run and whether it may be tolled is discussed, but only in the context of analyzing a particular court’s determination of the eligibility issue.

\textsuperscript{245} Wallace, \textit{supra} note 6, at 1248; \textit{see also} Shell, \textit{supra} note 36, at 421 (although law appears to play some role in arbitration, it “does not enjoy the official status in arbitration that it does in court”).


\textsuperscript{247} 475 U.S. 643 (1986).

\textsuperscript{248} \textit{Id.} at 648-49. In making that determination, there is a presumption of arbitrability. \textit{Id.} at 650; \textit{see also} First Options of Chicago, Inc. v. Kaplan, 115 S. Ct. 1920, 1924 (1995) (holding
permitted to rule on the merits of the underlying controversy. Once it is determined that the parties intended to submit the subject matter of the dispute to arbitration, the arbitrator, and not the court, then determines all "procedural questions which grow out of the dispute and bear on its final disposition." In John Wiley & Sons, Inc. v. Livingston, an issue arose as to whether the court or the arbitrator should determine whether a union abandoned its grievance by its failure to comply with a contractual provision requiring that notice of any grievance be filed with the Union Shop Steward within four weeks after the event's occurrence or latest existence. The Court held that the issue of timeliness was for the arbitrator. Thus, a distinction was drawn that the court determines "substantive arbitrability" issues while the arbitrators determine "procedural arbitrability" issues. The Supreme Court left procedural issues to the arbitrator because the issues are often intertwined with the merits of the dispute, and, if reserved for the courts, could produce duplication of effort and an opportunity for deliberate delay.

Most courts deemed the issue of whether a claim was filed timely to be a procedural one, subject to the arbitrator's jurisdiction. This was so regardless of whether the time bar was based on a contractual provision, an SRO arbitral forum procedural rule, or a state statute of limitations. As the First Circuit recently stated: "Thirty

that the presumption is reversed if the contract is silent or ambiguous as to whether the parties agreed to arbitrate the arbitrability issue).

249. AT&T Tech., Inc., 475 U.S. at 649-50.
252. Id. at 544.
253. Id.
255. John Wiley & Sons, Inc., 376 U.S. at 558; see also Town & Country Ford, Inc., 709 F.2d at 511.
256. See, e.g., County of Durham v. Richards & Assocs., 742 F.2d 811, 815 (4th Cir. 1984).
257. See, e.g., id. (stating that an agreement to arbitrate incorporated a two-year statute of limitations and that the issue of timeliness of arbitration is up to the arbitrator); Town & Country Ford, Inc., 709 F.2d at 512 (discussing whether grievance timely filed under contract provision was issue for arbitrators); Belke v. Merrill Lynch, Pierce, Fenner & Smith, 693 F.2d 1023, 1028 (8th Cir. 1982) (finding that arbitrator should decide the issue of whether party complied with contract provision requiring notice of intent to arbitrate within one year after accrual of cause of action).
258. O'Neel v. National Ass'n of Sec. Dealers, Inc., 667 F.2d 804, 807 (9th Cir. 1982) (holding that it is up to the arbitrator to determine whether arbitration is timely where code of arbitration contained a five-year time limit on submission).
259. Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 121 (2d Cir. 1991) (stating that "any limitations defense—whether stemming from the arbitration agreement, arbitration associ-
years of Supreme Court and federal circuit precedent have established that issues concerning the timeliness of a filed grievance are ‘classic’ procedural questions to be decided by an arbitrator . . . .”

Although the case law appeared settled that issues of timeliness are issues that should be addressed by the arbitrator, a split has developed in the circuits regarding the application of that law to the eligibility rule. The Seventh Circuit first addressed the issue, although not extensively, in Paine Webber, Inc. v. Farnam. There, the brokerage firm sought a declaration that it need not engage in an arbitration brought by a former customer due to the untimeliness of the submission pursuant to NASD Code section 15. The court itself determined that the claim was barred by section 15 after finding that the NASD considered section 15 to be an eligibility requirement, not a statute of limitations, and that it acted as an absolute bar to claims submitted more than six years after the event that gave rise to

_See supra note 216._

_870 F.2d at 1292._ The Court relied on a letter from an NASD staff attorney which stated: “In other words, the NASD will not process a claim that falls wholly outside the six year period.” _Id._ That statement does not indicate who should decide whether the claim is eligible. A fair reading suggests that the NASD itself would make that determination. Indeed, absent court litigation, the NASD Director of Arbitration currently decides eligibility issues if they are clear cut. If not clear cut, the issues go to the arbitrator. _Task Force Report, supra note 43, at 87,441._
Although the court did not explicitly state that the eligibility rule was a substantive limitation on the arbitrator's jurisdiction, it relied on a New York Court of Appeals case, which made a distinction between conditions precedent to arbitration, which the court determines, and procedural stipulations imposed by the parties to govern the conduct of the proceeding, which the arbitrator decides. Inasmuch as New York law had consistently held that issues of timeliness are subject to the court's jurisdiction, it is fair to assume that the court found the eligibility rule to be a condition precedent to arbitration and not a procedural stipulation.

The following year, the Third Circuit, in *PaineWebber, Inc. v. Hartmann*, analyzed NYSE Rule 603, the eligibility rule contained in the NYSE Code of Arbitration, within the context of the FAA. The Third Circuit reached the same result that the Seventh Circuit reached in *Farnam*. Because the eligibility issue arose in the context of a motion to compel arbitration pursuant to section 4 of the FAA, the

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265. *Farnam*, 870 F.2d at 1292. The consequence to investors of the court's finding that section 15 is not a statute of limitations is astounding. In a later case, *Edward D. Jones & Co. v. Sorrells*, 957 F.2d 509 (7th Cir. 1992), the court held that because the eligibility rule is not a statute of limitation, a claim that a broker-dealer fraudulently concealed his conduct cannot "toll" the six-year period, which commenced on the date of the transaction. *Id.* at 513. This result, of course, rewards the broker-dealer who can successfully conceal his or her wrongdoing. Even if one were to agree with the court that the eligibility rule is not a statute of limitations subject to tolling, that alone should not preclude the court from commencing the running of the six-year period from the date the customer discovered or should have discovered the misconduct. While this may be solely a matter of semantics, the result is needed to prevent broker-dealers from profiting from their fraudulent conduct.

266. The court relied on *In re Arbitration between the County of Rockland and Primiano Construction Co.*, 51 N.Y.2d 1 (1980), presumably because the contract provided that New York law would apply. *PaineWebber, Inc. v. Farnam*, 870 F.2d 1286, 1292 (7th Cir. 1989).

The court's reliance on New York law is today questionable in view of *Mastrobuono v. Shearson Lehman Hutton*, Inc., 115 S. Ct. 1212 (1995), where the court held that a choice-of-law clause in an arbitration agreement does not necessarily include the state's rules applicable to arbitration.

267. In *re Arbitration between the County of Rockland and Primiano Const. Co.*, 51 N.Y.2d at 8.


269. The Seventh Circuit upheld the result reached in *Farnam* three years later in *Edward D. Jones & Co. v. Sorrells*, 957 F.2d 509, 512 (7th Cir. 1992), and declined to revisit it more recently in *Smith Barney Inc. v. Schell*, 53 F.3d 807 (7th Cir. 1995).

270. 921 F.2d 507 (3d Cir. 1990).

271. NYSE Rule 603 is identical to NASD section 15.

272. *Hartmann*, 921 F.2d at 514; see also *PaineWebber, Inc. v. Hofmann*, 984 F.2d 1372 (3d Cir. 1993).

273. See *supra* note 96 and accompanying text (discussing the court's power to compel arbitration pursuant to the FAA).
court indicated that before it could grant the motion, it must engage in a limited review to ensure that the agreement to arbitrate was valid and that the specific dispute fell within the substantive scope of the agreement. With respect to the issue of whether the parties' dispute fell within the arbitration agreement, the court recognized that under AT&T Technologies, Inc. v. Communications Workers of America, it must operate under a presumption of arbitrability unless it could be said with positive assurance that the arbitration clause was not susceptible of an interpretation that covered the asserted dispute. The issue thus came down to the question of the scope of the agreement to arbitrate and whether Rule 603 had an impact on that scope.

PaineWebber argued that Rule 603 was intended to prevent PaineWebber from being forced to arbitrate a dispute that arose after the agreement to arbitrate had expired. In other words, PaineWebber argued that it agreed to arbitrate only those disputes falling within the six-year time period. The scope of the agreement was therefore limited to timely claims. The Hartmanns, on the other hand, responded that Rule 603 was not intended as a substantive limitation on the agreement to arbitrate, but rather as a procedural requirement governing the initiation of disputes that had already fallen within the substantive limits of the agreement to arbitrate. The Hartmanns relied on, among other things, the case law finding that timeliness claims were procedural issues that should be decided by the arbitrator. The court, while finding the Hartmanns' interpretation of Rule 603 to be "quite plausible," nonetheless agreed with PaineWebber and determined that Rule 603 supported PaineWebber's argument that the

274. Hartmann, 921 F.2d at 511. The court did not analyze whether the parties had by contract agreed to permit the arbitrator to determine the scope of their agreement to arbitrate. Id. at 514. Rather, the court found, as a logical corollary to the policy that a party cannot be compelled to arbitrate any dispute which he or she has not agreed to arbitrate, that a party cannot be required to arbitrate the threshold "dispute" of whether the underlying dispute is itself arbitrable. Id. The court, of course, should have reviewed the arbitration agreement to determine if the parties had included a provision setting forth who would determine issues of arbitrability. See First Options of Chicago, Inc. v. Kaplan, 115 S. Ct. 1920 (1995).

275. There was no dispute as to the validity of the agreement to arbitrate. Hartmann, 921 F.2d at 514.


277. Hartmann, 921 F.2d at 511.

278. Id.

279. Id. at 511-12.

280. Id.

281. Id.

282. Id. at 512.

283. Id.
parties intended to bar arbitration of disputes that fell outside the time requirements of the eligibility rule. In other words, the eligibility rule was a substantive limitation on the jurisdiction of the arbitral forum. The court relied on an expanded reading of Rule 603, the fact that the Farnam court, the only other circuit court to address the issue, came to the same conclusion, and the fact that the language of Rule 603 stood in stark contrast to the language at issue in the cases relied upon by the Hartmanns.

The court's rationale is flawed for a number of reasons. First, by relying on its expanded reading of the plain language of the rule, the court ignores the actual purpose and effect of the rule. The purpose was to keep stale claims out of arbitration. Thus, Rule 603 has the same purpose as a statute of limitations. The effect of Rule 603 is to bar from arbitration claims instituted more than six years from

284. Id.


While the Sixth Circuit has adopted the Seventh and Third Circuits' view that the court should determine eligibility, it has not conclusively determined whether it adopts their view that the six-year period may not be equitably tolled by fraudulent concealment. See, e.g., Dean Witter Reynolds, Inc. v. McCoy, 70 F.3d 1271, (6th Cir. 1995) (holding that an action for fraudulent concealment tolls the eligibility rule); First of Mich. Corp. v. Swick, 894 F. Supp. 298 (E.D. Mich. 1995) (fraudulent concealment, if proven, will toll eligibility rule); Nemecek, 886 F. Supp. at 1345 (same); Davis, 859 F. Supp. at 292-93 (same).

286. PaineWebber, Inc. v. Hartmann, 921 F.2d 507, 513 (3rd Cir. 1990).

287. The court expanded the plain language of the rule by incorporating definitions of the terms "eligibility" and "submission" into Rule 603. Id.

288. See supra note 218 and accompanying text (discussing that the rule was included in the UCA as a matter of convenience to prevent stale claims from going to arbitration).

289. Grant, supra note 57, at 138. Indeed, Professor Grant characterized the eligibility rule as a "private statute of limitations." Id.
the date of the occurrence or event giving rise to them.\textsuperscript{290} The eligibility rule looks and acts like a statute of limitations and the case law under the FAA mandates that such claims be determined by the arbitrator.\textsuperscript{291} That the eligibility rule was enacted as a "convenience" to the arbitral forum\textsuperscript{292} and was not intended to undermine substantive rights\textsuperscript{293} also strongly suggests that it is procedural in nature.\textsuperscript{294}

Second, the court's reliance on \textit{Farnam} is misplaced because \textit{Farnam} was based on New York law and not on the FAA.\textsuperscript{295} Third, the court ignored \textit{O'Neel}\textsuperscript{296} when it asserted that the language in Rule 603 was in "stark" contrast to the language found in the cases relied upon by the Hartmanns. In \textit{O'Neel}, the NASD Code of Arbitration contained a five-year time limitation which the court found to be procedural rather than substantive.\textsuperscript{297} Fourth, the time limitation set forth in the eligibility rule is not different, in any material way, from the time limitation set forth in the collective bargaining agreement at issue in \textit{John Wiley & Sons, Inc. v. Livingston}.\textsuperscript{298} Both may be conditions precedent to recovery, but "the fact that something is a condition precedent to arbitration does not make it any less a procedural question which grows out of the dispute and bears upon its final disposition."\textsuperscript{299} Finally, the result reached by the court is completely con-

\textsuperscript{290} See generally \textit{supra} note 220 and accompanying text.
\textsuperscript{291} See \textit{supra} note 256. While the rule is called "Time Limitation Upon Submission," the text of the rule indicates that claims falling outside the six-year period shall not be eligible for submission to arbitration. By using the term "eligible," SICA, when it drafted the UCA, unintentionally and unwittingly "elevate[d] a time limitation provision, which is at most a defense to the claim, to the same level as a limitation imposed upon the subject matter of the agreement to arbitrate." \textit{Harmann}, 921 F.2d at 515 (Sloviter, J., dissenting). Under the FAA, if the eligibility rule were to be treated like a statute of limitation, the arbitrators would clearly have the power to determine the timeliness of the claims submitted to arbitration. A claim that an action is time barred pursuant to the statute of limitations is a defense to an action and, accordingly, does not impact on the jurisdiction of the tribunal to determine its applicability. \textit{O'Neel} v. National Ass'n of Sec. Dealers, Inc., 667 F.2d 804, 807 (9th Cir. 1982).

\textsuperscript{292} See \textit{supra} note 218 and accompanying text.
\textsuperscript{293} See \textit{infra} note 415 and accompanying text (stating that the eligibility rule was not meant to limit an investor's substantive rights).
\textsuperscript{294} Jurisdictional limitations usually "reflect the concerns of power over the person and competence over the subject matter . . . ." \textit{Howlett v. Rose}, 496 U.S. 356, 381 (1990). The eligibility rule does not appear to be concerned with either of those two considerations, and accordingly, should not to be treated as a substantive limitation on the arbitrator's jurisdiction.

\textsuperscript{295} New York law permits a party to make an application to court to bar arbitration if the claim sought to be arbitrated is untimely pursuant to the statute of limitations. \textit{N.Y. Civ. Prac. L. & R. § 7502(b)} (McKinney 1996).

\textsuperscript{296} See \textit{supra} note 258 and accompanying text.
\textsuperscript{297} \textit{O'Neel} v. National Assn. of Sec. Dealers, Inc., 667 F.2d 804, 807 (9th Cir. 1982).
\textsuperscript{298} 376 U.S. 543, 556 n.11 (1964).
\textsuperscript{299} Local 285, Serv. Employees Int'l Union v. Nonotuck Resource Assocs., Inc., 64 F.3d 735, 740 (1st Cir. 1995).
trary to the substantive law of the FAA and to general principles of contract law.

Even if one were to agree with the court that the eligibility issue touched upon the scope of the arbitration agreement, the Supreme Court has mandated that "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." 300

By finding that the parties offered two "plausible" interpretations of Rule 603 and that the language of Rule 603 was not "crystal clear," 301 the Hartmann court recognized that doubt existed and the law required that that doubt be resolved in favor of arbitration, even though the issue involved a defense to the arbitration. 302 The court simply refused to compel arbitration because the doubt was not great enough. 303

The fact that the court found Rule 603 to be susceptible to two plausible interpretations indicates that Rule 603 is ambiguous. Contract law is quite clear that ambiguities in a contract are resolved against the party who drafted the agreement. 304 While the case does not indicate which party drafted the agreement, it can be assumed, from the common practice within the securities industry, that the contract was a standardized agreement that the Hartmanns were required to sign by PaineWebber. 305 Thus, the ambiguity should have led the court to compel arbitration, thereby reserving the issue of the timeliness of the dispute to the arbitrator. As the dissent in Hartmann stated: "We cannot assume that the arbitrator will not fairly decide the issue of timeliness of the demand." 306

The Supreme Court's recent decision in First Options of Chicago, Inc. v. Kaplan 307 casts considerable doubt on the result reached in

301. The Third Circuit later renounced these findings. In PaineWebber, Inc. v. Hofmann, 984 F.2d 1372 (3d Cir. 1993), Hofmann argued that the court in Hartmann determined a factual issue and, thus, did not preclude the possibility that section 15 of the NASD Code could have a contrary interpretation. Id. at 1378. The court rejected that argument stating: "We believe that our reasoning in Hartmann (though not our express holding) establishes that there is only one reasonable interpretation of section 15; namely, that the language of section 15 unequivocally establishes a substantive limitation on the claims that may be submitted to arbitration." Id.
303. While the Hartmann court tells us that a flicker of interpretive doubt is not enough to abide by the Supreme Court mandate, it does not tell us how much doubt would be enough.
305. See supra notes 45-51 and accompanying text (discussing the results of the GAO study).
Hartmann. There, the Court held that the contract of the parties controlled the issue of who should determine whether the parties have agreed to arbitrate a dispute and that state law controlled a court's interpretation of the contract. If the parties in their contract intended, pursuant to state law, for the arbitrator to determine arbitrability, then a court's review of the arbitrator's decision on that issue is limited. If, on the other hand, the contract is silent or ambiguous as to the question of who will determine the scope of the arbitration agreement, the court should do so; the presumption in favor of arbitrability is thus reversed when the contract is ambiguous. The Hartmann court failed to undertake this analysis.

If the analysis called for in First Options is indeed undertaken by the courts construing the standard arbitration clause, the result should be that the arbitrator determines issues of timeliness. The standard securities arbitration agreement typically provides that "any controversies" between the parties be submitted to arbitration. "Any controversies" presumably includes the controversy over who should determine the timeliness of the claims. Accordingly, under First Options, the arbitrators should determine whether a claim is time barred.

The Second Circuit recently came to this same conclusion using this very same analysis. In PaineWebber, Inc. v. Babyk, the brokerage firm sought a stay of arbitration, alleging that the investor's claims were time barred pursuant to the NASD eligibility rule. The client agreement, drafted by PaineWebber, provided for arbitration of "any and all controversies which may arise" concerning the account. It further provided that all claims were to be arbitrated in accordance with "the rules of the organization convening the panel." The investor was given the choice to arbitrate before the NASD, the NYSE or "any other national securities exchange's arbitration forum upon which PaineWebber is legally required to arbitrate." The investor chose the NASD.

In interpreting the client agreement, the court, following First Options, relied on New York law, which provides that the intent of the

308. Id. at 1924.
309. Id. at 1923.
310. Id.
311. See supra note 57 (including a standard client agreement containing a predispute arbitration clause requiring arbitration of any controversy arising out of the parties' transaction or agreement).
312. 81 F.3d 1193 (2d Cir. 1996).
313. Id. at 1196.
314. Id.
315. Id. at 1201.
parties governs interpretation of the contract. It found several provisions in the agreement evidencing the parties' intent to arbitrate the arbitrability issue. The court relied on, among other things, the "any and all" language of the predispute arbitration clause. The court found this language to be "inclusive, categorical, unconditional and unlimited."

The court also rejected PaineWebber's argument that the eligibility rule, which it characterized as a substantive limitation on arbitrability, required the court to determine the timeliness of the claim. The court, without agreeing or disagreeing with PaineWebber's characterization of the eligibility rule, concluded that the rule was not incorporated into the client agreement.

Recently, the Sixth, Tenth and Eleventh Circuits, purporting to undertake the analysis required by First Options, all came to the opposite conclusion. In Cogswell v. Merrill Lynch, Pierce, Fenner & Smith, Inc., Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cohen, and Securities Service Network, Inc. v. Cromwell, the courts, relying on the language of the eligibility rule, concluded that the parties intended for the court to determine the eligibility issue. At most, the Cohen court was willing to find the issue ambiguous and, relying on First Options, reversed the presumption in favor of arbitrability.

The courts' application of First Options is troubling. In attempting to ascertain the parties' intent, the courts chose to ignore the explicit language of the parties' agreements and instead relied solely on the language of the eligibility rule, which was merely incorporated

316. Id. at 1198-99.
317. Id. at 1199.
318. Id.
319. Id. at 1200.
320. Id. at 1201. The Second Circuit is the first court to come to this conclusion. The court also found that, even if the NASD Code of Arbitration was incorporated into the client agreement, the Code itself, through section 35, grants the arbitrator the power to interpret and apply the eligibility rule. Id.; see infra note 332 and accompanying text (discussing section 35).
321. 78 F.3d 474, 478-79 (10th Cir. 1996).
322. 62 F.3d 381, 384 (11th Cir. 1995).
324. Cohen, 62 F.3d at 384.
325. A lower federal court has held that the Cohen and Cromwell courts did not properly construe First Options when they reversed the presumption in favor of arbitrability. In PaineWebber, Inc. v. Landay, 903 F. Supp. 193, 200 (D. Mass. 1995), the court explained that the Sixth and Eleventh Circuits misconstrued First Options when they analyzed the eligibility issue as one involving whether a valid agreement to arbitrate existed in the first instance, rather than as a secondary issue concerning the scope of a valid agreement. If the proper construction had been applied, the presumption in favor of arbitration would not have been reversed. Id. at 199-200.
into the agreements by the courts, without discussion or explanation. The language of the agreements, like all standard predispute arbitration clauses used by the securities industry, provided that any or all controversies would be submitted to arbitration.\textsuperscript{326} It is that language that the investor most likely read and understood. It is highly unlikely that the investor was made aware of or otherwise knew of the specifics of the eligibility rule, and it seems patently illogical and unfair to rely on that rule to ascertain the investor's intent.\textsuperscript{327}

In the final analysis, the \textit{Hartmann} decision is disturbing, not so much because the court's reasoning was flawed, but because the decision demonstrates an unwillingness to evaluate the arbitrability issue in the context of the Hartmanns' unequal bargaining power. The court concluded that the parties intended to limit the scope of their agreement to timely claims.\textsuperscript{328} It is highly unlikely that the Hartmanns were aware of or had any knowledge of the contents of the eligibility rule when they signed the Customer Agreement. Typically, a Customer Agreement merely states that the arbitration will be governed by the rules of the SRO forum chosen by the customer. It does not set forth the content of each and every rule contained in an SRO's code of arbitration procedure and there is nothing in the agreement that would otherwise alert an investor to the time limitation. Even assuming \textit{arguendo} that parties may agree to limit their arbitration agreement in a "temporal sense,"\textsuperscript{329} such a limitation is typically

\textsuperscript{326} Cogswell v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 78 F.3d 474, 475 (10th Cir. 1996) (investor agreed that "any controversy" arising out of agreement shall be submitted to arbitration); Cohen, 62 F.3d at 382 (parties "entered into a Customer Agreement requiring that all disputes be resolved by arbitration pursuant to the NASD Code of Arbitration"). The \textit{Cromwell} opinion does not provide the language of the agreement requiring arbitration, but it can be assumed that the language was similar to the standard predispute arbitration clause and required the arbitration of any or all controversies between the parties related to the investor's account. \textit{See supra} note 311 and accompanying text (discussing the language of the standard arbitration clause).

\textsuperscript{327} The court in \textit{Singer} v. Smith Barney Shearson, No. 96-6130-CIV, 1996 WL 245381, *5 (S.D. Fla. Apr. 22, 1996), declined to follow \textit{Cohen} and distinguished it on the basis that a provision similar to the one contained in the client agreement in \textit{Singer} was not quoted in \textit{Cohen}. The client agreement in \textit{Singer} assigned "[a]ny controversy arising out of or relating to . . . this agreement to arbitration." The existence of this language, missing in the \textit{Cohen} opinion, led the court to conclude that the parties intended for the arbitrator to determine the eligibility issue. The basis upon which the court distinguished \textit{Cohen} is certainly questionable in view of the fact that the court in \textit{Cohen}, while not quoting the specific language of the agreement at issue there, did state that "all" disputes between the parties were to be resolved by arbitration. The \textit{Singer} court apparently believed that the explicit language of the contract, rather than the language of the eligibility rule, should control the issue of the parties' intent pursuant to \textit{First Options}, and needed a basis upon which to ignore precedent, without appearing to do so.

\textsuperscript{328} PaineWebber, Inc. v. Hartmann, 921 F.2d 507, 513 (3d Cir. 1990).

\textsuperscript{329} \textit{Id.} at 511.
explicitly disclosed in the agreement and is the result of mutual, arms-length negotiation. In view of the lack of information made available to the Hartmanns and their lack of power to alter or amend any of the terms of the Customer Agreement, it is disingenuous to assert that they, or any other investor for that matter, intended to be bound by a time limitation different than that provided for in the applicable state or federal statute of limitations. The court’s failure to examine or recognize the unequal bargaining position of the Hartmanns in determining their intent to limit the scope of the agreement, and its failure to distinguish the cases where the time limitation was expressly set forth in the agreement, improperly deprived the Hartmanns of the arbitral forum for the determination of the timeliness of their claims.

The Eighth Circuit in FSC Securities Corp. v. Free was the first circuit to split, but not by disagreeing with the Third and Seventh Circuits as to whether the eligibility rule was a substantive or procedural limitation on the jurisdiction of the arbitrator, but by finding that the parties had intended that the arbitrators would determine the applicability of the eligibility rule by inclusion of section 35 of the NASD Code of Arbitration Procedure into their agreement. Section 35 provides: “The arbitrators shall be empowered to interpret and determine the applicability of all provisions of this Code . . . . [which] shall be final and binding upon the parties.”

Although federal law is clear that issues of arbitrability shall be determined by the court, the parties are free to “clearly and unmistakably” provide otherwise. In finding that the inclusion of section 35 evidenced a “clear and unmistakable” intent to have the arbitrators decide the issue, the Freel court reasoned that when the parties expressly agree to have their dispute governed by the NASD Code, they adopt the entire code, including section 35. The court found that

330. 14 F.3d 1310 (8th Cir. 1994).
331. While the Freel decision did not directly conflict with the Seventh Circuit's holding regarding section 15, it did so with respect to its holding regarding section 35. In Edward D. Jones & Co. v. Sorrells, 957 F.2d 509, 514 (7th Cir. 1992), the court, without explanation, held that section 35 was not a clear and unmistakable expression that the parties intended for the arbitrators to define their own jurisdiction. See also Cogswell v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 78 F.3d 474, 480 (10th Cir. 1996) (finding that section 15 took precedence over the more general provision of section 35); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cohen, 62 F.3d 381, 384 (11th Cir. 1995) (holding that section 35 is not “clear and unmistakable evidence” of the parties’ intent to allow the arbitrator to determine the timeliness of the claim).
332. NASD CODE OF ARBITRATION PROCEDURE, supra note 216, § 35; Eighth Report, supra note 30, at 18-19. Section 35 is derived from the UCA, section 22. Id.
334. Freel, 14 F.3d at 1312.
section 35, in no uncertain terms, "commits interpretation of all provisions of the NASD Code to the arbitrators." The court would not render section 35 a nullity by refusing to apply it to the arbitrator's decision regarding the application of section 15.

The court's reliance on section 35 is sound. Section 15 is silent as to who shall make the determination as to eligibility. Section 35, applicable to all the provisions of the Code, fills in that silence by unambiguously giving the arbitrators the power to interpret and determine the applicability of section 15. Moreover, when a court determines eligibility, it has to interpret the meaning of the phrase "occurrence or event giving rise to the controversy" contained in section 15. That is arguably a violation of section 35, which leaves that interpretation to the arbitrators, and is contrary to the parties' intention to have their controversy settled by arbitration. Finally, if a court is going to charge an investor with the knowledge of the arbitration code provi-

335. Id. By relying on section 35, the court was able to avoid making a determination as to whether section 15 was procedural or substantive. The district court had found that it was procedural, relying on Automotive, Petroleum & Allied Industries Employees Union v. Town & Country Ford, Inc., 709 F.2d 509 (8th Cir. 1983), and used section 35 as an alternative ground for its holding. FSC Sec. Corp. v. Freel, 811 F. Supp. 439, 443-45 (D. Minn. 1993).

336. Freel, 14 F.3d at 1312. The court indicated that if the parties had desired that the arbitrator have less discretion than that provided for by section 35, they could have easily limited it by contract. Id.

The Tenth Circuit recently held that section 35 does not evidence an intent to have the arbitrator decide the timeliness issue. In Cogswell v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 78 F.3d 474 (10th Cir. 1996), the court held that section 15 was a substantive eligibility requirement. Id. at 480. The court found that the parties did not intend for the arbitrator to determine the eligibility issue when they included section 35 in their agreement. Id. Section 35 was found to be unclear and was deemed a general contract term which was qualified by the more specific terms of section 15. Id.; see also Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cohen, 62 F.3d 381, 384 (11th Cir. 1995) (observing that, at most, section 35 makes the parties' intent ambiguous and, therefore, the presumption in favor of arbitrability is lost pursuant to First Options); Securities Serv. Network, Inc. v. Cromwell, No. 94-5778, 1995 U.S. App. LEXIS 22540, at *7 (6th Cir. Aug. 1, 1995), cert. denied, 116 S. Ct. 708 (1996) (holding that section 35 alone does not constitute the "requisite clear and unmistakable [sic] evidence that the parties intended and agreed to arbitrate the issue of arbitrability"). But see PaineWebber, Inc. v. Bybyk, 81 F.3d 1193, 1201 (2d Cir. 1996) (stating in dicta that section 35 grants the arbitrator power to interpret and apply section 15); Conroy v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 899 F. Supp. 1471, 1476 (W.D.N.C. 1995) (holding that section 35, in part, mandates that the arbitrator determine issues of eligibility).

337. Section 15 is not exempt from the coverage of section 35.

338. The Seventh Circuit requires the court to determine the meaning of "occurrence or event." Edward D. Jones & Co. v. Sorrells, 957 F.2d 509, 514 (7th Cir. 1992). The Third Circuit does not follow the Seventh Circuit's approach and instead requires that if there is a dispute as to what constitutes the relevant occurrence or event or when the occurrence or event took place, the court must first determine, by looking at the language of the contract and all relevant extrinsic evidence, whether the parties intended to submit those disputes to the arbitrators. See PaineWebber, Inc. v. Hofmann, 984 F.2d 1372 (3d Cir. 1993); Merrill Lynch, Pierce, Fenner & Smith v. Masland, 896 F. Supp. 396 (M.D. Pa. 1995).
sions of the SRO, it only seems fair to charge them with one that does not have the effect of depriving the investor of substantive rights to which he or she would have been entitled had the investor not agreed to arbitrate the matter in the first instance.

The Fifth Circuit more recently determined that NASD section 15 and AMEX Rule 605 are procedural limitations on arbitrability that should be determined by the arbitrator. The court in *Smith Barney Shearson, Inc. v. Boone* rejected Smith Barney’s assertion that section 15 and Rule 605 are prerequisites to the arbitrator’s jurisdiction. The court based its decision on *John Wiley & Sons, Inc. v. Livingston* and other labor arbitration cases where similar timeliness issues were characterized as procedural. The court did not rely solely on the “plain language” of the eligibility rule as the Third Circuit had. Rather, it focused on the actual effect of the provision and saw the provision for what it is: a time bar. The court also found that the broad language of the arbitration agreement indicated that the parties intended to have “any controversy,” including procedural requirements, resolved through arbitration.

It seems likely that the First, Ninth, and District of Columbia Circuits will join the Second, Fifth and Eighth Circuits when presented

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339. AMEX Rule 605 is identical to NASD section 15 in all material respects.
340. 47 F.3d 750 (5th Cir. 1995).
341. *Id.* at 754.
343. *Boone*, 47 F.3d at 753-54. The only exception to the rule that timeliness issues are procedural is if the timeliness issue will bar arbitration altogether. *Id.* at 754. That exception was not applicable in *Boone* because there was a dispute as to whether the time bar would actually bar arbitration. The parties disputed when the last act or occurrence giving rise to the claims took place and whether the time bar should have been tolled due to fraudulent concealment. *Id.*
344. *Id.*
345. *Id.*
346. Prior to PaineWebber, Inc. v. Babyk, 81 F.3d 1193 (2d Cir. 1996), a conflict had developed in the lower courts of the Second Circuit regarding the applicability of Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114 (2d Cir. 1991), to the SRO eligibility rule. In *Wagoner*, the Second Circuit stated, albeit in dicta, that issues of timeliness stemming from arbitration association rules are procedural and should be determined by the arbitrator. That dicta was followed in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Noonan*, 92 Civ. 3770 (SWK), 1992 U.S. Dist. LEXIS 11363, at *27-28 (S.D.N.Y. Aug. 3, 1992), where the court, relying on NASD Code section 35 and *Wagoner*, determined that the arbitrator should decide whether certain claims were time barred under the eligibility rule. The same result was reached in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Shaddock*, 822 F. Supp. 125 (S.D.N.Y. 1993). However, in PaineWebber, Inc. v. Richardson, 94 Civ. 3104 (AGS), 1995 U.S. Dist. LEXIS 5317, at *1 (S.D.N.Y. Apr. 21, 1995), the court permanently stayed arbitration of claims that were time barred under the eligibility rule. The court distinguished *Wagoner* and *Shaddock* on the basis that a state statute of limitations was at issue in those cases. *Id.* at *4*. The court also determined that it was not even required to give those cases any weight in view of *Smith Barney, Harris Upham & Co. v. Luckie*, 85 N.Y.2d 193, *cert. denied*, 116 S. Ct. 59 (1995), where the New York
squarely with the eligibility issue. Although the timeliness issue did not arise in the context of a securities claim, the First Circuit recently reaffirmed the rule, first laid down in *John Wiley & Sons, Inc. v. Livingstone*, that timeliness issues are procedural and thus up to the arbitrator to decide. The District of Columbia Circuit has come to the Court of Appeals held that the New York rule requiring the court to decide state of limitations defenses was not preempted by the FAA. There are a variety of problems with that conclusion.

The *Richardson* court's reliance on *Luckie* is problematic. First, the court stated that it was constrained to apply the ruling in *Luckie* because the action was a diversity action. The law, however, is quite clear that even in diversity actions the court must follow the FAA and not state law if the contract calling for arbitration concerns a transaction involving interstate commerce. The only basis upon which the court could have followed *Luckie* was if the contract contained a choice of law provision specifying that the law of the State of New York would govern the dispute. But even if the agreement stated that New York law would apply, there are still problems with the court's reliance on *Luckie*. *Luckie* involved the question of whether New York law, CPLR section 7502(b), was preempted by the FAA. *Luckie* did not involve the eligibility rule. If the court was unwilling to follow *Wagoner* because it did not involve interpretation of the eligibility rule, *Luckie* too should not have been deemed controlling. Moreover, the holding in *Luckie* is questionable. *Luckie* applied the CPLR to the contract because of the choice of law provision. The Supreme Court, two weeks after *Luckie* was decided, ruled in *Mastrobuono* that a choice of law provision does not necessarily mean that the parties intended to include state arbitration rules in the choice of law provision. Thus, in the absence of a finding of an intent to include within the contract the state arbitration rules, the law governing the FAA would apply and statute of limitations defenses would accordingly be determined by the arbitrator. The Second Circuit in *Babyk* rejected *Luckie* for precisely this reason. 81 F.3d at 1200. *But see* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ohnuma, 630 N.Y.S.2d 724 (N.Y. App. Div. 1995) (*Mastrobuono* did not alter the result in *Luckie*).


The opposite conclusion was reached in Cigna Securities, Inc. v. Calby, No. 3:92CV345-P, 1993 U.S. Dist. LEXIS 19941 (W.D.N.C. June 8, 1993), where the court held that the eligibility rule is a substantive limit on arbitrator's power and in *PaineWebber, Inc. v. Allen*, Civ. A. No. 3:92CV591, 1993 WL 773623 (E.D. Va. Apr. 29, 1993), *aff'd*, 45 F.3d 427 (4th Cir. 1995) (per curiam), where the court found ineligible a RICO claim even though it appeared to be within the statute of limitations. However, the issues on appeal in *Allen* involved the court's subject matter jurisdiction and whether the district court erred in applying the six-year eligibility rule instead of the RICO statute of limitations. The Fourth Circuit affirmed, without discussion, the application of the six-year eligibility rule to the RICO claim. The court did not discuss, apparently because it was not raised on appeal, whether the lower court had properly determined that it had the power to determine the timeliness of the RICO claim under the eligibility rule.

*348. Local 285 Serv. Employees of Int'l Union v. Nonotuck Resources Assocs. Inc., 64 F.3d 735, 739-40 (1st Cir. 1995); see also PaineWebber, Inc. v. Landay, 903 F. Supp. 193, 198 (D. Mass. 1995) (holding that issues of eligibility are to be determined by the arbitrator).*
same conclusion. Finally, in *O’Neel v. National Ass’n of Securities Dealers, Inc.*, the Ninth Circuit ruled that the arbitrator should determine if a claim was time barred pursuant to the NASD eligibility rule. The court treated the code provision as a statute of limitations and specifically renounced the argument that “the defense of the statute of limitations goes to jurisdiction of the tribunal, whether it be judicial or arbitration.”

The broad language of the standard arbitration clause alone should dictate that the arbitrator decide the eligibility issue. If that alone is not enough, the existence of section 35 coupled with the federal policy favoring arbitration should be. The arbitrator should determine eligibility issues for the additional reason that a determination of eligibility may indeed involve the decision-maker in the merits of the underlying dispute. The Supreme Court has been emphatic that in determining arbitrability, the court is not to rule on the potential merits of the dispute and a court cannot avoid the merits if it is determining the timeliness of a claim.

2. *The Consequences of a Finding of Ineligibility*

The majority of courts that have considered the consequence to an investor of a finding that a claim is ineligible, and therefore barred from arbitration, have ruled that the investor is also barred from litigating the claim in a judicial forum, even though the claim may still be

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350. 667 F.2d 804 (9th Cir. 1982).
351. *Id.* at 807.
352. *Id.* In Soares Financial Group, Inc. v. Hansten, No. C 93-4172, 1994 U.S. Dist. LEXIS 8245, at *7 (N.D. Cal. June 16, 1994), both the customer and the NASD took the position that interpretation of section 15 lies within the exclusive province of the arbitrator. The court, relying on *O’Neel*, agreed. *Id.*
353. The split in the circuit courts has had the effect of causing parties to forum shop. The Seventh Circuit rejected a blatant and aggressive attempt at forum shopping by a brokerage firm, Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Lauer, 49 F.3d 323 (7th Cir. 1995). In that case, the Lauers initiated an arbitration with the NASD. *Id.* at 325. At the request of the Lauers, the NASD selected Tampa, Florida, where the Lauers resided, for the hearing site. Merrill Lynch thereafter filed an action in the federal court in Illinois, rather than in the federal court in Florida, seeking to compel arbitration in that district. It also sought the elimination of ineligible claims and the Lauers’ request for punitive damages. Merrill Lynch’s attempt to get the case out of Florida was motivated solely to obtain a more favorable result on the eligibility issue. If the decision compelling arbitration rested with the Florida rather than the Illinois federal court, potentially stale claims may have gone to the arbitrator for resolution. If the Northern District of Illinois decided arbitrability, the Lauers, as the court explained, would have “lost all a chunk of their claims.” *Id.* at 325-26.
355. *Id.* at 557.
timely under the applicable statute of limitations. Those courts have come to that conclusion by interpreting the SRO code of arbitration procedure in conjunction with the standard arbitration clause. That conclusion, which is not required by the Code or the standard arbitration clause, is contrary to federal law, and ignores the unequal bargaining power between the investor and the broker-dealer.

Dean Witter Reynolds, Inc. v. McCoy contains the most extensive discussion of the issue to date. There, Dean Witter sought a declaratory judgment and injunction against defending claims before the NASD. After ruling that the occurrence or event giving rise to the claim was the date of the investment, not the date of discovery of the wrongdoing or the date of "injury," and that fraudulent concealment by the broker-dealer could not toll the six-year time period, the court found the claims to be ineligible. The court then hit the investors with yet another whammy: the investors were barred from litigating in court those claims found ineligible. In so holding, the court, pursuant to the FAA, looked to the terms of the parties' agreement. Like all standardized arbitration clauses, the clause here provided that "[a]ny controversy . . . arising out of or relating to this contract or breach thereof, shall be settled by arbitration. . . ." The customer was given the choice of arbitration before the AAA or the NYSE and the agreement provided that the arbitration shall take place in accordance with the rules of whichever forum the customer elected.


357. See supra note 315.


359. Id. at 1025.


361. McCoy, 853 F. Supp. at 1030. The customers argued that the ineligible claims were nevertheless timely under state limitations periods. Id. at 1034. The court, assuming arguendo that the customers did have the right to proceed with ineligible claims in court, nevertheless held that the claims must be dismissed because they were time barred by the applicable statutes of limitations. Id.

362. Id. at 1033.

363. Id. at 1027.

364. Id.
turned out, the parties further agreed to arbitrate before the NASD.\textsuperscript{365}

The court found that the language of the agreement was unambiguous and that the parties' clear intent was to have all disputes resolved through arbitration.\textsuperscript{366} That plain language thereby precluded the use of a judicial forum for noneligible claims; the customers apparently waived their right to litigate their claims in a court in favor of arbitration.\textsuperscript{367} The court came to this conclusion even though the agreement did not contain a specific provision waiving the right to litigate ineligible claims in a judicial forum.\textsuperscript{368} The court further maintained that if the investors had wanted to exclude ineligible claims from the coverage of the arbitration clause, they could have expressly done so.\textsuperscript{369} That argument, of course, makes the underlying assumption that when they signed the contracts, the investors knew they were waiving the right to bring timely claims in arbitration. The Sixth Circuit agreed with the lower court, stating that it was undisputed that the customers "voluntarily entered into an arbitration agreement with Dean Witter that clearly intends for all disputes to be resolved exclusively through arbitration."\textsuperscript{370}

\textsuperscript{365} Id. at 1023. That was a fatal mistake. The investor should have elected to proceed before the AAA because the AAA does not have a comparable eligibility rule. Instead the applicable statute of limitations governing the claim will determine its timeliness. Grant, supra note 57, at 155 n.16.

\textsuperscript{366} McCoy, 853 F. Supp. at 1033.

\textsuperscript{367} Id. at 1030.

\textsuperscript{368} Id. Other courts have interpreted more direct "waiver" language to find that the investor forfeited the right to bring timely claims in arbitration and in court. In Conroy, the court found that the parties clearly agreed to pursue all potential disputes in arbitration and not in court when they included the following language in the agreement: "[t]he parties are waiving their right to seek remedies in court, including the right to jury trial." 899 F. Supp. at 1476. Securities firms are required by SRO rules to include this boilerplate waiver language in arbitration agreements. See infra note 379 (discussing this requirement of the SRO rules).

\textsuperscript{369} McCoy, 853 F. Supp. at 1033.

\textsuperscript{370} No. 94-5779, 1995 U.S. App. LEXIS 37080, at *6-7 (6th Cir. Nov. 27, 1995). The Fifth Circuit came to the same conclusion. In Kramer v. Smith Barney, 80 F.3d 1080 (5th Cir. 1996), the court, relying on the very same language relied on in McCoy, found the intention underlying the agreement to require submission of all claims to arbitration. The court stated that it would be "bizarre" to interpret the agreement so as to exempt stale claims from arbitration. The court's characterization that the claims were stale was based, of course, on the eligibility rule, not on the applicable statute of limitations. Id. at 1086. One must wonder if the court would have come to the same conclusion if the eligibility rule had provided for a shorter time period, such as six months or a year. It could hardly be argued that claims six months or a year old are stale. The court's inconsistent use of the language contained in the standard predispute arbitration clause is painfully obvious. The clause, specifically the language that "any controversies . . . shall be submitted to arbitration," has been interpreted to deprive the investor of the right to proceed in a judicial forum with ineligible claims. Yet that same clause has not been interpreted to find that the parties intended arbitration of the controversy concerning the timeliness of the claim pursuant to the eligibility rule. See supra notes 262-331 and accompanying text. It is indeed
A more plausible interpretation of the standard predispute arbitration clause is that the parties, when they agreed to arbitrate any controversy pursuant to the chosen forum's rules, agreed to arbitrate only those controversies that are deemed eligible for arbitration according to those rules. That reading would reserve the ineligible claims for a judicial forum. This seems to be the interpretation adopted by the courts that have upheld the customer's right to maintain ineligible claims in a judicial forum. Indeed, these courts assumed, without examination of the arbitration clause, the availability of a judicial forum for ineligible claims. Although some courts have rejected these cases for precisely that assumption, such an assumption comports with the most natural understanding of an agreement to arbitrate. In other words, an agreement to arbitrate is an agreement waiving the right to go to a judicial forum, but only to the extent that the arbitral forum, for whatever reason, is willing to accept the claim.

Ironic that the broker-dealer, the drafter of the clause, receives the benefit of its broadness, but not the burden of it, and that the investor, who has no power to alter or amend the clause, is deprived of a judicial forum with respect to ineligible claims and an arbitral forum with respect to the eligibility issue.


It is not inconsistent to allow the investor to argue that he or she was agreeing to arbitrate only eligible claims and at the same time prohibit the broker-dealer from arguing that he or she only agreed to arbitrate eligible claims when deciding who should determine the issue of eligibility. The broker-dealer, not the customer, drafted the agreement and had the power to clarify his or her intentions.


373. If the eligibility rule is amended, rather than eliminated, and the amendment does not bar maintenance of ineligible claims before a judicial forum, the situation may develop where a customer has eligible and ineligible claims. If the ineligible claims go to court, two proceedings could conceivably take place involving related claims. While this result would undoubtedly be wasteful, it would be necessary to preserve the investor's substantive rights. However, at least one court, relying on section 15, ordered ineligible and eligible claims to arbitration to avoid the maintenance of two separate proceedings. In Prudential Securities, Inc. v. Seimetz, No. 5:93 CV 0647, 1993 U.S. Dist. LEXIS 16358 (N.D. Ohio May 21, 1993), the court was called upon to determine the eligibility of certain claims. After stating that the parties may be forced to engage in two separate proceedings, one before the arbitration panel for clearly eligible claims and one before the court for the arguably ineligible claims, the court ordered both types of claims to arbitration in order to avoid duplicative, time-consuming and expensive proceedings. Id. at *6. But see LaPlant, 829 F. Supp. at 1239 (D. Kan. 1993) (holding that although ineligible claims would be subject to litigation in court, in accordance with Seimetz, it was unwilling to order ineligible claims to arbitration even though such result was appealing from a judicial economy and litigation efficiency standpoint).
The ineligibility of class actions for SRO arbitration exemplifies this point. SICA amended the UCA to exempt from arbitration claims filed as class actions. The SROs adopted the amendment and the SEC approved it. The amended rule states that such claims are not eligible for submission to arbitration. That ineligibility does not now mean that when an investor signs an agreement to arbitrate "any" controversy with his or her broker-dealer and his or her claim turns out to be part of a class action, he or she is precluded from seeking redress for that class action claim in a judicial forum. No one would dare suggest that result, even if the agreement did not specifically indicate that class actions are exempt from arbitration.

Even if one were not to agree that it is more plausible that the investor intended to arbitrate only eligible claims, as that term is defined by the SRO arbitral forum, at the very least, such an interpretation is equally as plausible, thereby making the agreement ambiguous. That ambiguity alone should permit the litigation of the ineligible claims in a judicial forum. Ambiguous terms in contracts are construed against the interests of the party who drafted them. Here, Dean Witter, the likely drafter of the agreement and the party in the superior bargaining position, could have indicated that the agreement included a waiver of a judicial forum for both eligible and ineligible claims. Because Dean Witter did not so indicate, the investor should have been permitted to litigate the claims in a judicial forum. It is patently unfair to put the onus on the investor to provide for a judicial forum for ineligible claims inasmuch as the investor has no awareness of the eligibility rule and the broker-dealer did nothing.

374. See Eighth Report, supra note 30, at 6-7.
376. See, e.g., NASD CODE OF ARBITRATION PROCEDURE, § 12(d)(1) (Mar. 1995). When amending its Code of Arbitration Procedure, the NASD also amended its Rules of Fair Practice to require that predispute arbitration agreements contain a notice that class actions may not be arbitrated. Release No. 31371, supra note 375. If notice is required for the exclusion of class actions from arbitration, it must be questioned why explicit notice is not required for the exclusion of ineligible claims, where the case is even more compelling for notice inasmuch as ineligible claims, unlike class action claims, cannot be maintained in a judicial forum.
378. It is fair to assume, in accordance with industry custom, that Dean Witter drafted the agreement and was unwilling to negotiate the clause.
in the agreement itself to alert the investor to it.\textsuperscript{379} Moreover, it is unrealistic that an investor, even if he or she knew of the six-year rule, could get the broker-dealer to amend the standard arbitration clause. The evidence is clear that such clauses are not negotiable.\textsuperscript{380} Dean Witter drafted the agreement and the ambiguity should be construed against it—not against the powerless investor.

This is precisely the approach the Supreme Court took in Mastrobuono v. Shearson Lehman Hutton, Inc.\textsuperscript{381} There, an issue arose as to whether a customer waived the right to have an arbitrator assess punitive damages when it signed an arbitration agreement containing a provision providing for the application of New York law.\textsuperscript{382} New York law prohibits the awarding of punitive damages by arbitrators.\textsuperscript{383} Because the Court found the agreement to be ambiguous, the Court refused to interpret it in a manner that would cause the investor to unintentionally give up an important substantive right.\textsuperscript{384} The Court held that the agreement should not be read to preclude the arbitrator from awarding punitive damages:

[R]espondents cannot overcome the common-law rule of contract interpretation that a court should construe ambiguous language against the interest of the party that drafted it. Respondents drafted an ambiguous document, and they cannot now claim the benefit of the doubt. The reason for the rule is to protect the party who did not choose the language from an unintended or unfair result. That rationale is well-suited to the facts of this case. As a practical matter, it seems unlikely that the petitioners were actually aware of New York’s bifurcated approach to punitive damages, or that they had any idea that by signing a standard-form agreement to arbitrate disputes they might be giving up an important substantive right. In the face of such doubt, we are unwilling to impute this intent to petitioners.\textsuperscript{385}

\textsuperscript{379} SRO rules provide that certain disclosures regarding the nature of arbitration be contained in the agreement between the investor and the securities firm. For example, New York Stock Exchange Rule 636(a) requires that a predispute arbitration clause notify an investor that (i) arbitration is final and binding on the parties; (ii) the parties are waiving their right to seek remedies in court; (iii) prearbitration discovery is generally more limited and different from court proceedings; (iv) the arbitrator’s award is not required to include factual findings or legal reasoning and any parties’ right to appeal or seek modification of rulings by arbitrators is strictly limited; and (v) the panel of arbitrators will typically include a minority of arbitrators who were or are affiliated with the securities industry. NYSE Rule 636(a); see also UCA § 31, Eighth Report, supra note 30, at 24. There is no requirement that the customer be notified of the eligibility rule and its effect on an otherwise timely claim.

\textsuperscript{380} See supra note 51 and accompanying text (discussing the results of the GAO Report).

\textsuperscript{381} 115 S. Ct. 1212 (1995).

\textsuperscript{382} Id. at 1215.

\textsuperscript{383} Id.

\textsuperscript{384} Id. at 1219.

\textsuperscript{385} Id. (citations omitted).
It cannot be disputed that the result in *McCoy* was not only unintended, but unforeseen, by the investors.\(^{386}\) Indeed, defendants argued that if a waiver was found, it should only be deemed a partial waiver, not one waiving substantive rights.\(^{387}\) Although the defendants’ argument was sound and amply supported by prior Supreme Court pronouncements, the court was not persuaded; it was unable to discern “how an agreement . . . to limit the resolution of any disputes between them to NASD arbitration instead of litigation in the courts constitutes a waiver of the defendants’ substantive rights.”\(^{388}\) The court was looking at the issue too broadly and too generally. The investors were not arguing that arbitration as an alternative means of dispute resolution resulted in the waiver of substantive rights. Rather, the waiver resulted from the application of the forum’s eligibility rule.

If the majority of the courts are correct that the customer does, in fact, waive bringing timely claims in an arbitral and judicial forum when they agree to arbitrate future controversies, the customer is unknowingly relinquishing a substantive right. The substantive law of a cause of action gives a party the right to bring the action within a specific time period. If a party has a claim that is within that time period, that party has a substantive right. The existence of the eligibility rule coupled with the courts’ interpretation of the standard arbitration clause deprives the investor of this substantive right.\(^{389}\) Thus, the investor is not receiving in the arbitral forum the same rights that he or she would have been entitled to receive in the judicial forum. This result goes well beyond what parties bargain for when they agree to arbitrate. It is generally understood that certain procedural protections are done away with in arbitration. It is not known, expected or understood that the right to seek redress of a timely claim itself is given up in exchange for the simplified procedures of the arbitral forum.

The Supreme Court, when it endorsed SRO arbitration, did so on the basis that the streamlined procedures do not result in the loss of

\(^{386}\) Surely the clause considered in *McCoy* is no less ambiguous than the one considered in *Mastrobuono*. In *Mastrobuono*, the contract provided that it would be “governed by the laws of the State of New York.” *Id.* at 1216. The Court found that an ambiguity existed regarding whether that clause included New York’s procedural rules applicable to arbitration or whether it just covered the substantive law of New York. *Id.* at 1217-18.


\(^{388}\) *Id.*

\(^{389}\) See Dean Witter Reynolds, Inc. v. McCoy, No. 94-5779, U.S. App. LEXIS 37080, at *7 (6th Cir. Nov. 27, 1995) (Moore, J., dissenting) (noting that the refusal to apply equitable tolling principles to eligibility rule results in denying the investor’s substantive right to pursue “stale” claims if he or she can prove fraudulent concealment).
substantive rights.\textsuperscript{390} In \textit{Rodriguez de Quijas v. Shearson/American Express, Inc.},\textsuperscript{391} the Court held that certain procedural provisions, not substantive provisions, contained in the Securities Act could be waived by agreeing to arbitrate a controversy.\textsuperscript{392} The SRO’s attempt to keep “stale” claims out of arbitration through the device of the eligibility rule has the effect of depriving unsuspecting customers of important substantive rights. The Supreme Court has expressed an unwillingness to interpret ambiguous language in the standard arbitration agreement so as to deprive a customer of a substantive right.\textsuperscript{393} The same result is warranted with respect to the eligibility rule. If a customer has failed to bring a claim within the six-year period specified by the eligibility rule, that customer should not then be barred from bringing that claim in a judicial forum if indeed the claim is timely pursuant to the applicable statute of limitations.

Clearly, if the SRO arbitral forum’s procedural rules, or, for that matter, the agreement to arbitrate, contained a provision requiring the submission to arbitration of claims alleging violation of the Securities Act within a time period shorter than that provided for in the Securities Act, there would be no dispute that the provision or the agreement was improper. The Supreme Court has declared that the substantive rights afforded by statute cannot be waived and the SEC has unequivocally stated that a predispute arbitration clause cannot be “used to curtail any rights that a party may otherwise have had in a judicial forum,”\textsuperscript{394} nor may such clause “be used to shorten applicable statutes of limitation.”\textsuperscript{395}

The Fifth Circuit declared void the eligibility rule contained in the AMEX Code of Arbitration to the extent that it impaired an investor’s substantive rights under the Employee Retirement Income Security Act of 1974 (ERISA).\textsuperscript{396} In \textit{Kramer}, the investor asserted both ERISA and non-ERISA claims.\textsuperscript{397} The investor argued that the ERISA claims were timely pursuant to both the eligibility rule\textsuperscript{398} and the

\textsuperscript{390} See supra note 192 and accompanying text (discussing the McMahon Court’s analysis).
\textsuperscript{391} 490 U.S. 477 (1989).
\textsuperscript{392} \textit{Id.} at 481.
\textsuperscript{393} \textit{Id.} at 485.
\textsuperscript{395} \textit{Id.}
\textsuperscript{396} Kramer v. Smith Barney, 80 F.3d 1080 (5th Cir. 1996).
\textsuperscript{397} \textit{Id.} at 1082.
\textsuperscript{398} \textit{Id.} at 1084.
The claims, however, were time barred pursuant to the eligibility rule. The court held that the eligibility rule, to the extent it rendered timely claims under ERISA ineligible for arbitration, resulted in a waiver of substantive rights under ERISA, which ERISA explicitly prohibited. Accordingly, the court ordered the arbitration of the ERISA claims and left the determination of their compliance with the time requirements of ERISA to the arbitrator.

With respect to the non-ERISA claims, the court held that it was bound to give preclusive effect to a judgment by a New York state court finding the claims ineligible for arbitration. The court further refused to require a judicial forum for the adjudication of the ineligible claims. The court’s refusal to order the ineligible but timely state law claims to a judicial forum deprived the investor of substantive rights granted by the state law. The court did not explain why it was permissible to deprive the investor of rights derived from the applicable state statute of limitations but impermissible with respect to the rights derived from the ERISA statute of limitations. The anti-waiver language of ERISA does not provide a complete explanation. Even if one were to agree that a state statute of limitations, unlike the ERISA statute of limitations, can be waived by the investor, it can hardly be maintained that the investor knowingly waived it when he or she signed the agreement. The waiver comes about through the application of the eligibility rule, which, of course, is not explicitly stated in the agreement and which is not otherwise brought to the attention of the investor.

Similarly, in Graham Oil Co. v. Arco Products Co., the Ninth Circuit permitted a gasoline distribution franchisee to sue a franchisor in court despite the existence of an arbitration agreement. The court found that the arbitration agreement, which expressly required the franchisee to forfeit the one-year statute of limitations period contained in the Petroleum Marketing Practices Act, violated the Act.

399. The ERISA six-year statute of limitations permitted tolling in cases of fraud or concealment. Id.
400. Id. at 1085.
401. Id.
402. Id. at 1085 n.4.
403. Id. at 1086.
404. Id.
405. 43 F.3d 1244 (9th Cir. 1994), cert. denied, 116 S. Ct. 275 (1995).
406. Id. at 1246.
407. Id. at 1247.
The court severed the arbitration clause from the remainder of the agreement.\textsuperscript{408}

The eligibility rule should be treated no differently and should likewise be found improper. The rule has the same purpose and effect as a statute of limitations. The fact that the claims forfeited by customers due to the eligibility rule will be mostly state common law claims should not affect the analysis. The origin of the rights asserted should not matter. What is significant for the analysis is that claims are being forfeited, and what is particularly egregious is that the forfeiture was not made known to the investor when he or she signed the agreement containing the arbitration clause. As the Ninth Circuit stated: "\textit{[T]he fact that franchisees may agree to an arbitral forum for the resolution of statutory disputes in no way suggests that they may be forced by those with dominant economic power to surrender the statutorily-mandated rights and benefits that Congress intended them to possess.}"\textsuperscript{409} Similarly, investors should not be forced to give up the limitations period (with its accrual and discovery rules) that Congress, state legislatures, or state or federal courts intend them to possess.

Various justifications have been advanced by the courts barring litigation in a judicial forum of ineligible claims. One justification, which has already been discussed, is that the investor could have reserved for himself or herself in the arbitration agreement the right to bring ineligible claims in a judicial forum.\textsuperscript{410} That justification appears to almost wilfully ignore the reality of an investor's bargaining position with the securities firm and it is manifestly misleading by creating the impression that the investor had any bargaining power to make that reservation in the first instance. As the GAO Report found, the customer is effectively precluded from making any amendments to the arbitration clause.\textsuperscript{411} In other words, the customer is unable to protect himself or herself in the manner suggested by the courts.

Another justification offered is that if the court were to allow a customer to bring ineligible claims in a judicial forum, such result would encourage a customer seeking to avoid arbitration to wait until the SRO time period expired and then bring the action in federal or state court.\textsuperscript{412} That justification is specious. It is hard to imagine that an

\begin{itemize}
\item \textsuperscript{408} Id. at 1248.
\item \textsuperscript{409} Id. at 1247.
\item \textsuperscript{410} Dean Witter Reynolds, Inc. v. McCoy, 853 F. Supp. 1023, 1030 (E.D. Tenn. 1994).
\item \textsuperscript{411} GAO Report, supra note 28, at 30.
investor would knowingly sit on a claim and risk being untimely in violation of a statutory limitation period just to avoid having to bring the claim in an arbitral forum. Moreover, this is particularly unlikely inasmuch as a customer may have the benefit of bringing certain claims in arbitration that he or she would not be permitted to bring in the judicial forum. For example, a claim alleging that a broker-dealer violated the SRO suitability rule would probably not be cognizable in court but would be allowed in arbitration.413

3. SICA's Position

As discussed, the eligibility rule in its present form in the SROs' arbitration procedure codes is derived from the eligibility rule as originally drafted by SICA, as amended in 1984.414 However, SICA did not intend for the rule to deprive a customer of his or her right to bring ineligible claims in a judicial forum.415 Accordingly, SICA amended its rule in April 1993416 to make it conform to its original intent and make it clear that a claim found to be ineligible is nevertheless permitted to go to a judicial forum, despite the existence of the predispute arbitration clause.417 SICA also amended the rule to clar-

174 (N.D. Tex. 1994) (noting that interpreting the arbitration clause as barring a judicial forum for ineligible claims serves as an impetus for the parties to present their disputes in a timely fashion).

413. THOMAS L. HAZEN, SECURITIES REGULATION 504 (3d ed. 1996).

414. The 1984 amendments basically made clear that the eligibility rule would not act as a bar if a court of competent jurisdiction ordered the case to arbitration.

415. As stated by Professor Katsoris, an original member of SICA, "The clear intent was not to create a new statute of limitation, nor was it intended to prevent somebody from asserting their remedy elsewhere, absent the six year rule." NYSE Symposium, supra note 12, at 1533; see also Katsoris, Should McMahon Be Revisited?, supra note 6, at 1123 (stating the the "eligibility rule was never intended to limit or eradicate claimants' rights. Unfortunately, some courts have interpreted this rule as substantive instead of merely procedural, thus denying claimant's relief after the six years elapsed."); Task Force Report, supra note 43, at 87,440.


417. The amended rule provides:

(a) No dispute, claim or controversy shall be eligible for submission to arbitration under this Code if six (6) years have elapsed from the occurrence or event giving rise to the act or the dispute, claim, or controversy. This section shall not extend applicable statutes of limitation.

(b) Where eligibility is disputed by a responding party after service of the Statement of Claim, the Director of Arbitration shall promptly make a final determination as to whether a claim is eligible for arbitration. Any such determination regarding eligibility shall set forth the occurrence or event which was the basis for the determination of eligibility of the dispute, claim or controversy. The identification of the occurrence or event which formed the basis for a determination that a claim is eligible shall not limit
ify that the director of arbitration shall make the eligibility determination.418

No SRO has adopted the SICA 1993 amendment to the eligibility rule.419 The NASD filed a notice in October 1993 with the SEC proposing amendments to section 15 which were almost identical to the SICA amendment.420 That proposal was apparently withdrawn. The NASD again proposed to amend section 15 in July 1994.421 That amendment, although still similar to the amended eligibility rule contained in the UCA, substantially expanded the October 1993 proposed amendment.422 The July 1994 proposal was withdrawn as well.423 However, in that proposal, the NASD confirmed that the original in-

any parties' right to offer evidence to the arbitrators which relates to their substantive claims or defenses.

(c) A determination by the Director of Arbitration pursuant to subparagraph (b) that a claim is ineligible shall not constitute a bar to asserting the underlying claim in a judicial forum. The parties will have available to them the rights and remedies provided by applicable law, notwithstanding, any (i) existing predispute arbitration agreement or (ii) decision of eligibility. No party shall seek to enforce any agreement to arbitrate where the claim has been determined to be ineligible under this section.

Eighth Report, supra note 30, at 9.

418. That amendment was a compromise among SICA members. Some believed that the arbitrators should make the eligibility determination. NYSE Symposium, supra note 12, at 1539.

419. Katsoris, Should McMahon Be Revisited?, supra note 6, at 1131.


421. See Release No. 34442, supra note 416.

422. Id.

423. Telephone Interview with Ethan Corey, Staff Attorney at the SEC (June 19, 1995). For a discussion as to the details and merits of the NASD's second proposal, see Bukhman, Time Limitations on Arbitrability, supra note 230.


The task force recommended that the NASD eligibility rule be suspended for a three-year period and be replaced with procedures to resolve dispositive motions on statute of limitations grounds. The task force called for the early resolution of such motions by the arbitration panel and recommended that the motions be decided on the papers, unless an evidentiary hearing was required to resolve fact issues. It was also recommended that the arbitrators provide written opinions setting forth their reasoning on the statute of limitations issue and it was suggested that arbitrators receive special training regarding such issues. Task Force Report, supra note 43, at 87,442-43. Professor Katsoris, while favoring the elimination of the eligibility rule, did not favor the "conditions" the task force imposed for the suspension of the rule. Katsoris, SICA, supra note 59, at 532.
tent of the eligibility rule was not to bar a judicial forum for ineligible claims.\textsuperscript{424}

While the NASD has attempted to amend its eligibility rule, the fact of the matter is that no SRO has adopted the SICA amendment, the very purpose of which is to conform the rule to its original meaning. The SROs have no incentive to do so inasmuch as the eligibility rule, as interpreted by most courts, is much more favorable to the members of the SROs than it is to the investors.\textsuperscript{425} If that is indeed the reason, then the SROs not only "undermine SICA's efforts to achieve a level playing field"\textsuperscript{426} between investor and broker-dealer but are also reneging on their promises and representations made to the SEC. As will be recalled, the SEC was poised to take action with respect to SRO arbitration procedures and declined to do so on the basis that SICA, consisting of members from the securities industry and from the public alike, reformed SRO arbitration procedures, which were found to be in the public interest.\textsuperscript{427} It is beyond dispute that the SROs' position on the eligibility rule is not only inconsistent with the public interest but is contrary to SICA's position as well.

4. The SEC's Position

The SEC has the authority to require an SRO to adopt rules with respect to the conduct of arbitrations.\textsuperscript{428} Indeed, that authority may

\textsuperscript{424} Exchange Act Release No. 34442, supra note 416. "The eligibility rule never was intended to serve as an election of remedy provision that would eviscerate any surviving causes of action under applicable law after six years have elapsed." Id. at 6.

This language was omitted from the first notice of the proposed rule change published in October 1993. The investors in Calabria v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 855 F. Supp. 172, 176-77 (N.D. Tex. 1994) and in Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Shelapinsky, Civ. A. No. 93-1553, 1994 U.S. Dist. LEXIS 10477, at *14 (E.D. Pa. Mar. 10, 1994), relying on the first notice to amend the eligibility rule, argued that the eligibility rule should not be interpreted so as to deprive them of a judicial forum for their ineligible claims and used the proposed rule in support of their argument. The courts were not persuaded that the proposed rule change required it to allow the ineligible claims to proceed in a judicial forum because the amendment had not yet been adopted and there was no indication that the amendment represented the original intent of section 15. A very different result may have been reached if the first notice had contained the language contained in the second notice.

\textsuperscript{425} While the eligibility rule has caused much contentious litigation, see Exchange Act Release No. 34442, supra note 416, at 11, which is both costly and time-consuming and contradicts the concept behind requiring disputes to go to an arbitral forum, the securities firms will continue to litigate as long as the costs do not exceed what the investor would get on the claim. It is unlikely that the costs will exceed the claim inasmuch as the eligibility issue is usually determined early in the litigation pursuant to a motion to dismiss.

\textsuperscript{426} Katsoris, \textit{Should McMahon Be Revisited?}, supra note 6, at 1149.

\textsuperscript{427} See supra note 77 and accompanying text (discussing the SEC's deferral of its own action regarding a single system for customer disputes).

\textsuperscript{428} See supra note 66 and accompanying text (noting that the SEC has the power to request that the SROs amend their own rules to provide for a dispute resolution system).
have influenced the Court's decision in *McMahon*. The Court seemed to rely, in part, on the SEC's oversight authority to ensure the fairness of the SRO arbitration process. The presence of the SEC may have relieved the Court of the burden of examining in detail the procedures to which an investor is subjected when he or she agrees to arbitrate. The authority given to the SEC over the SRO rules was touted as the one change that caused the SEC to amend its position on arbitration and to endorse it before the Court in *McMahon*.

The SEC has exercised its oversight authority to some extent. During 1986 and 1987, the SEC staff conducted a review of SRO arbitration. It found that securities industry arbitration generally operated fairly but that certain improvements were needed. Shortly after *McMahon*, the SEC sent SICA a letter containing a list of areas where changes were needed. The SEC recommended, among other things, that the standards for eligibility to serve as a public arbitrator be revised; that the SRO disclose to the parties the background and affiliations of the arbitrators; that procedures be developed for the written explanation of the arbitrators' award; that discovery be expanded; that a record of the proceedings be made; and that programs be instituted for training and evaluation of the arbitrators. The UCA was overhauled in 1989 to incorporate the changes suggested by the SEC and to make other changes that the SROs and SICA suggested. None of those changes, however, involved the eligibility rule. In fact, the SEC has not taken a position with respect to the appropriateness or legality of the eligibility rule. The SEC has been criticized as taking action only to diffuse the controversy surrounding the predispute arbitration clause and not taking action to equalize the relationship between the broker-dealer and investor. That criticism certainly rings true with respect to the eligibility rule.

The SEC has knowledge of the controversy surrounding the eligibility rule. It published the NASD's proposed amendments to section

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429. See supra note 194-96 and accompanying text (noting the SEC's change in position regarding securities arbitration which influenced the Court's decision in *McMahon*).

430. Id.

431. Id.


433. Id.


435. McGuire & Love, supra note 66, at 437; see also Grant, supra note 6, at 515-16 (noting that the SEC suggested fifteen specific improvements).


437. Gregory & Schneider, supra note 6, at 1247-48.
15, which amendments contained a detailed account of conflicting case law. It also has knowledge that SICA amended the eligibility rule and that no SRO has since adopted that amendment. While the SEC may not be faulted for initially giving the securities industry an opportunity to amend its rules, it certainly can be faulted for not stepping in when those SROs flagrantly declined to adopt the SICA amendment to the eligibility rule. The SEC relinquished its plan to create a quasi-independent agency to handle customer and broker-dealer disputes in reliance on the promises made by the industry that it would sponsor arbitration in a fair and just manner. The industry has failed to follow through on that promise and the SEC has not held it accountable. If the public cannot trust the SEC to override the securities industry's self-serving position with respect to the eligibility rule, the public's perception of SRO arbitration will never improve and the future of SRO arbitration may be jeopardized. An investor may be able to convince the Supreme Court that the SEC has not provided the oversight that the Court relied upon in the McMahon decision. The SEC apparently thinks arbitration is a good thing for both investors and broker-dealers and it presumably would not want to see the Court revisit McMahon.

5. Fairness Studies

Various studies have been conducted that provide a level of comfort to those questioning the actual fairness of SRO arbitration. Those studies indicate that SRO arbitration is fair in fact, so to say, and that the real problem is the perception of fairness that the public has, due to the fact that the arbitral forum is sponsored by the securities industry. Those fairness studies, however, should not end the inquiry into the actual fairness of SRO arbitration because they do not take into account the investor who has been deprived of both an arbitral and judicial forum for the resolution of ineligible claims.

a. SRO Arbitration Versus a Judicial Forum

There have been a variety of studies conducted to determine if investors fare as well in arbitration as they would in litigation. While the studies are not definitive and various problems have been identified with each, the consensus seems to be that "customers are not

438. See supra note 419.
439. See Fletcher, supra note 91, at 97-104 (discussing studies conducted by the SROs, a brokerage house and an accounting firm for a national stock exchange); see also Grant, supra note 6, at 399-402; Gregory & Schneider, supra note 6, at 1240-44.
440. Fletcher, supra note 91, at 99-104.
obviously more likely to recover more in one forum than the other." That conclusion is based on comparing the amount recovered in litigation versus the amount recovered in arbitration. That conclusion fails to take into account the customer who recovers nothing because he or she has been deprived of a forum for the resolution of his or her claim. The NASD has indicated that there are numerous claims that SROs reject because of ineligibility even before they are served on the securities firms. Obviously those claims are not included in the figures inasmuch as they are unknown to the brokerage firms and they do not even reach the arbitration panel for a ruling. Until the ineligible customer is included in the figures, the actual fairness of SRO arbitration vis-a-vis a judicial forum cannot be determined.

b. SRO Arbitration Versus AAA Securities Arbitration

The GAO was directed to analyze the results of securities arbitration at industry-sponsored forums and to compare those results with those of the AAA, the primary independent forum for securities arbitration. The purpose was to determine if the nonindependent status of the SRO arbitral forums had any bearing on the ability of the customer to recover. The GAO concluded that the forum at which the decision was made did not affect an investor's chances of receiving an award. About sixty percent of investors received an award at SRO forums and at the AAA and the award averaged about sixty percent of the amount claimed. While that conclusion may lend support to the argument that SRO arbitration is fair, there was nothing in the report indicating that it considered ineligible claims in its analysis. The failure to do so is critical. The SRO forums all have the eligibility rule, the AAA does not. Accordingly, a person who has a claim where more than six years have elapsed from the date of the occurrence or event giving rise to the claim would be ineligible to proceed in an SRO forum but would be permitted to proceed and recover at the AAA (assuming, of course, that the claim is timely pursuant to the applicable statute of limitations). Obviously, SRO arbitration is not as
fair as AAA arbitration with respect to the investor with the timely but ineligible claim.

V. A SUGGESTED APPROACH

When the Supreme Court endorsed SRO arbitration, it did so on a wholesale basis. The Court adopted it completely, without examination or analysis of any of the specific procedures contained in the SRO code of arbitration procedure. Only the overall structure of arbitration was analyzed. Only the general procedures were examined. The overall structure and the general procedures were accepted by the Supreme Court as being adequate. That acceptance has apparently led to the unfortunate conclusion that the specific procedures adopted by the arbitral forum are immune from examination.

Generally, the procedural rules enacted by a forum will govern the controversy at hand, regardless of the origin of the rights being asserted. Thus, if an action based on state law is brought in federal court due to diversity jurisdiction, the Federal Rules of Civil Procedure will govern.\textsuperscript{450} Similarly, when an action is brought in state court, based on its concurrent jurisdiction, for a violation of federal law, the state court's procedural rules will typically apply.\textsuperscript{451} This general rule leads one to assume that when an action is brought in an arbitral forum, based on its "consensual" jurisdiction, the procedural rules of the arbitral forum will govern, regardless of whether the claim is based on state or federal law.\textsuperscript{452} Thus, if the parties consent to the NASD arbitral forum, the NASD's Code of Arbitration Procedure will control.

The above-stated general rule, that the forum's procedural rules will govern the dispute before it, is not, however, blindly applied. For example, while the general rule, "bottomed deeply in the belief in the importance of state control of state judicial procedure, is that federal law takes the state courts as it finds them,"\textsuperscript{453} it is not applicable when those rules "impose unnecessary burdens upon rights of recovery authorized by federal law."\textsuperscript{454} In Brown v. Western Railway of Ala-

\textsuperscript{450} Hanna v. Plumer, 380 U.S. 460, 464 (1965); Sibbach v. Wilson & Co., 312 U.S. 1, 10 (1941).
\textsuperscript{452} The procedural rules are usually deemed to be incorporated into the parties' agreement.
\textsuperscript{453} Felder, 487 U.S. at 150 (quoting Henry M. Hart, Jr., The Relations Between State and Federal Law, 54 COLUM. L. REV. 489, 508 (1954)).
\textsuperscript{454} Brown v. Western Ry. of Ala., 338 U.S. 294, 298 (1949); see also Southland Corp. v. Keating, 465 U.S. 1, 31 (1984) (O'Connor, J., dissenting) ("It is settled that a state court must honor federally created rights and that it may not unreasonably undermine them by invoking contrary local procedure.").
an action was brought in state court alleging violations of the Federal Employers' Liability Act. The action was dismissed by the state court when the court, following a state rule of practice, construed the pleadings "most strongly" against the pleader. The Supreme Court rejected the contention that the state court's local practice of construction of the complaint was binding upon it. The federal right of having the court construe the complaint itself to determine if the claimant had been denied a right to trial granted to him by Congress could not be defeated by "forms of local practice." While a state court could impose such strict rules on the assertion of state conferred rights, it could not do so with respect to federally created rights.

A similar result was reached in Felder v. Casey. There, the issue was whether a state court could apply a state notice-of-claim rule to a section 1983 claim. Wisconsin required that before a plaintiff could sue a governmental entity or officer, he or she must first notify the potential defendant or defendants of the circumstances giving rise to the claim, the amount of the claim and his or her intention to hold the person notified liable. The plaintiff was also required to postpone filing suit for 120 days after providing notice to give the potential defendants the opportunity to consider the relief requested. Failure to comply with the rule resulted in a dismissal of the action. The Supreme Court held it improper, under the Supremacy Clause, for the state court to apply the state rule to the federal civil rights action, notwithstanding the fact that the plaintiff voluntarily chose to bring the action in state court. The Court held that the Supremacy Clause imposes upon the state court a constitutional duty to "proceed in such manner that all the substantive rights of the parties under controlling federal law [are] protected." The Court further stated:

Wisconsin, however, may not alter the outcome of federal claims it chooses to entertain in its courts by demanding compliance with outcome-determinative rules that are inapplicable when such claims are brought in federal court, for "[w]hatever springes the State may

455. 338 U.S. 294 (1949).
456. Id. at 294.
457. Id. at 295.
458. Id. at 296.
459. Id.
461. Id. at 134.
462. Id.
463. Id.
464. Id.
465. Id. at 138.
466. Id. at 151 (quoting Garrett v. Moore-McCormack Co., 317 U.S. 239, 245 (1942)).
set for those who are endeavoring to assert rights that the State con-
fers, the assertion of federal rights, when plainly and reasonably
made, is not to be defeated under the name of local practice."\textsuperscript{467}

The Court was particularly concerned with the effect of the notice-of-
claim statute on the assertion of a claim based on the federal civil
rights laws.\textsuperscript{468} It found that the Wisconsin statute, designed as a con-
dition precedent to recovery in all civil rights actions, had the effect of
reducing the time period within which to bring suit.\textsuperscript{469}

The Court's analysis in \textit{Brown} and in \textit{Felder} provides a framework
for determining the appropriateness of a specific procedural rule app-
licable in an SRO arbitral forum. It would be axiomatic that an arbi-
tral forum handling a federal claim is not held to the same set of rules
as that of a state court when handling a federal claim.

An SRO arbitral forum handles claims based on federal and state
law and claims based on violations of SRO rules. Like a state court
hearing federal claims or a federal court hearing state claims, the pro-
cedural rules of the arbitral forum should apply unless they impose
unnecessary burdens upon the right to recover under the law of the
claim being asserted.\textsuperscript{470} When the forum is resolving federal and state
law claims, its rules should thus be examined to determine whether
any of them impose unnecessary burdens upon the right to recovery
authorized by that law. Thus far, no court has undertaken this inquiry
with respect to the eligibility rule. When arbitration was initially
viewed with judicial hostility, it was because of a fear that its process,
lack of procedures and informality would not protect federal statutory
rights. A reexamination of the arbitration process led the Court to
deem it adequate. When engaged in that reexamination, the Court
was not concerned with the burdens imposed by an arbitral forum's
procedures. Rather, the concern centered on just the opposite, that is
whether, in view of the informality and lack of procedures, federal
statutory rights could nonetheless be protected. In view of the eligi-
bility rule, the time has now come for the courts to examine the bur-
den the rule imposes on the right to recovery under either state or
federal law.

\textsuperscript{467} Id. at 152 (quoting \textit{Brown v. Western Ry. of Ala.}, 338 U.S. 294, 298-99 (1949)).
\textsuperscript{468} Id. at 137.
\textsuperscript{469} Id. at 143-44.
\textsuperscript{470} The arbitral forum may apply its rules, in their entirety, to causes of action based on
violations of their own rules. In \textit{Brown}, the Court made it clear that although certain rules may
not be applicable when a state court is entertaining a federal claim, those same rules may indeed
be applicable when the state court is handling claims derived from rights the state conferred. 338
U.S. at 298-99.
The eligibility rule undoubtedly imposes a burden on the right to seek redress; it is a condition precedent to recovery in the arbitral forum. It is outcome-determinative, like the notice-of-claim rule in *Felder*. If a claimant has a cause of action which is timely pursuant to the applicable statute of limitations, the action may proceed in state court or federal court. It could not proceed, however, in the arbitral forum if, even though timely, six years elapsed from the occurrence or event giving rise to the suit. Thus, the outcome of that claim will depend upon where it is brought. If a state court cannot apply outcome determinative rules to federal claims, then arbitral forums should be barred as well from applying the eligibility rule to state and federal claims. The same is true for a federal court hearing a state law claim. The federal court may not impose its own substantive, outcome-determinative law on the matter; it must apply state law to state law claims.\footnote{Erie R.R. Co. v. Tompkins, 304 U.S. 64, 78 (1938).}

An arbitral forum should not be deemed immune from these rules because it has “consensual” jurisdiction. It cannot be asserted that because the parties consented to the arbitral forum, they consented to the application of any procedural rule, even those that are outcome determinative. The Court rejected this precise argument in *Felder*.\footnote{487 U.S. 131 (1988).} There it was argued that litigants who chose a state court forum for the vindication of a federal right did so to take advantage of certain procedural rules and, having taken advantage of these rules, must also comply with those procedural rules less to their liking.\footnote{Id. at 150.} This “bitter-with-the-sweet argument”\footnote{Id.} did not persuade the Court. The Court stated that “states may make the litigation of federal rights as congenial as they see fit—not as a quid pro quo for compliance with other, uncongenial rules, but because such congeniality does not stand as an obstacle to the accomplishment of Congress’ goals.”\footnote{Id. at 151.} Likewise, arbitral forums may make the vindication of claims based on either state or federal law as informal, expeditious or simple as they see fit, but the fact that such advantages have been found to be adequate in the protection of federal statutory rights does not give an arbitral forum the license to tread upon the very rights being vindicated by the application of burdensome procedural rules. The fact that the plaintiff in *Felder* voluntarily chose state court did not mean that he was required to give up substantive rights he would have had absent that choice.
Similarly, the fact that an investor may be deemed to have "consented" to the arbitral forum does not mean that he or she must relinquish substantive rights that he or she would have had absent the arbitration clause.

Like the notice-of-claim statute in *Felder*, the eligibility rule is more than a mere rule of procedure. It is an outcome-determinative rule that limits an investor's right to sue a broker-dealer and as such underlines the state and federal substantive law granting the investor the cause of action. The causes of action asserted in arbitration are derived from state and federal law, which already contain their own statutes of limitations. The SROs' attempt to alter those limitation periods for their own convenience is improper. If a state court may not "vindicate the substantive interests underlying a state rule of decision at the expense of a federal right," an arbitral forum may not do so either. Accordingly, the rule should be eliminated.

**VI. Conclusion**

There is a federal policy favoring arbitration. That is because arbitration is, for the most part, an effective, efficient, and economical alternative dispute resolution process. It can greatly benefit a party by giving him or her a forum to pursue a claim that he or she may otherwise not have been able to pursue; by having a fact finder with expertise and understanding of the intricacies of the dispute; and by having an arbitrator, while subject to the law, not strictly bound by it so that "justice" can be achieved. The federal policy and the theoretical benefits of arbitration, however, cannot support the wholesale endorsement of securities arbitration. Securities arbitration is a special case deserving special analysis and treatment. When determining the legality or applicability of an SRO arbitration rule, courts and arbitrators alike must be guided by the fact that the securities industry makes the rules that are applicable in each SRO arbitral forum and that the investor has no bargaining power to amend or obtain waiver of those rules. Accordingly, interpretation and construction of the arbitration agreement and the SRO procedural rules governing arbitration should be done in a manner that does not deprive the customer of claims or substantive rights the customer would have had absent the agreement to arbitrate.

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476. *Id.* at 152.

477. See *supra* note 218 and accompanying text (discussing the eligibility rule's original intent as a "convenience").

The control of the arbitral process by the securities industry has resulted in investors being placed in a position where they are forced to relinquish substantive rights for the benefit of being a participant in the capital market. For the most part, courts have upheld that relinquishment by failing to take into account the unique position of the investor and the assumption underlying the Supreme Court’s endorsement of arbitration. Instead of the wholesale endorsement of securities arbitration, the courts should treat the SRO arbitral forum as it would treat a state or federal court forum and examine whether the procedures applicable in the forum tread upon federal or state substantive rights. That examination should lead to the abandonment of the eligibility rule.