SEC Explores Opening Door to Arbitration

Agency to Study Option That Could Let Firms Limit Holder Lawsuits

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Kara Scannell
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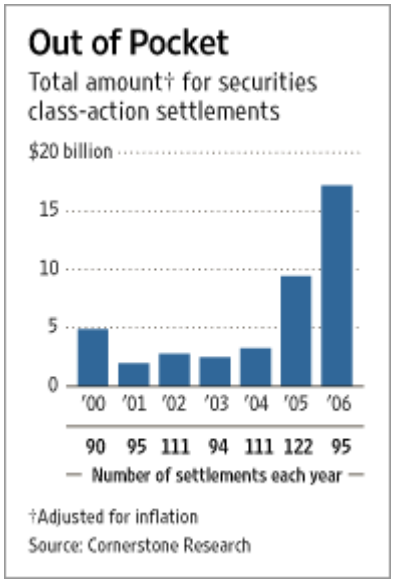
WASHINGTON -- The Securities and Exchange Commission is exploring a new policy that could permit companies to resolve complaints by aggrieved shareholders through arbitration, limiting shareholders' ability to sue in court.

The initiative is at the discussion stage and may not lead to any changes in rules or practices. But any move toward arbitration could realign the balance of power between shareholders and corporate managements at a time when that balance has tipped increasingly toward shareholders. It could also limit shareholders' ability to recover money damages or other compensation from corporations.

The idea of giving companies the option of arbitrating shareholder disputes is likely to spark fierce opposition from both investor-rights groups and trial lawyers. As a result, there's a good chance that it could fall flat.



The SEC staff is studying whether corporations should be permitted to amend their bylaws to allow for arbitration, a change that in some cases might require shareholder approval, according to people familiar with the matter. The study comes after the idea was raised by private commissions looking into concerns about the competitiveness of U.S. financial markets, these people said.

The initiative could become part of a broader package of SEC proposals, including a controversial measure to let shareholders change company bylaws to allow them to nominate their own directors on corporate ballots. That measure has been opposed by the business lobby, which argues it could entrench special interests. However, the SEC might seek to make it more palatable to business by packaging it with changes that business would support, like the option to use arbitration.

In an interview Friday, however, SEC Chairman Christopher Cox sounded a cautious note. "I don't believe arbitration is a panacea," he said.

Business groups, some academics and others have long argued that the potential for shareholder lawsuits has helped to dull the competitive edge of U.S. financial markets. Last year, U.S. companies paid $17.16 billion to settle a total of 95 shareholder class-

action lawsuits alleging misdeeds ranging from securities fraud to accounting irregularities, according to data from Cornerstone Research.

Critics of these lawsuits say multimillion-dollar settlements have lined the pockets of lawyers at the expense of shareholders, created burdensome costs, and frightened off companies that might otherwise have chosen to list their stocks in the U.S.

The idea of using arbitration to resolve disputes between companies and their shareholders was recommended in November by a blue-ribbon committee led by Harvard Law Professor Hal Scott, and encouraged by Treasury Secretary Henry Paulson.

Among other things, the panel's report said, the "SEC should permit public companies to contract with their investors to provide for alternative procedures in securities litigations, including providing for arbitration (with or without class-action procedures) or non-jury trials." The report recommended a shareholder vote for companies seeking to change their bylaws to allow for arbitration.

The idea may be addressed at an SEC roundtable, a forum in which the SEC invites people from all sides to debate an issue and help the agency's staff review the options.

Mr. Cox, the SEC chairman, has a history of seeking to limit what he sees as excessive securities litigation. While a Republican congressman representing Southern California, he helped write the 1995 Private Securities Litigation Reform act, which aimed to reduce the number of frivolous lawsuits filed against corporations. Earlier this year, the SEC sided with business in a "friend of the court" brief it filed in a Supreme Court case dealing with the standards a plaintiff needed to meet for a case to proceed. The SEC says it sided with the standard accepted by the majority of appeals courts.

Many kinds of disputes have already moved out of the courtroom and into arbitration. Brokerage firms, for example, require clients to agree to resolve claims before arbitration panels. Companies also routinely include arbitration clauses in contracts with each other and with employees.

Critics of arbitration say the three-member arbitration panels used in brokerage disputes often favor the industry over the consumer. In arbitration, the extent of a consumer's right to receive and review relevant information from the opposing side, a process known as discovery, is less clear than in litigation. Arbitration hearings also are often conducted in private, rather than in a public forum.

In 2006, 42% of investors who filed arbitration claims against brokers received some form of compensation, down from 53% in 2000, according the National Association of Securities Dealers.

Trial lawyers have lost ground in several high court cases in recent years. An SEC move toward permitting shareholder disputes to be resolved through arbitration could further reduce the influence of the so-called plaintiffs bar.

Although settlement amounts are up significantly from past years, the overall number of securities class-action lawsuits filed has declined to its lowest level in 10 years, according to a joint study Cornerstone Research and Stanford Law School.

The latest SEC discussions are part of a series of initiatives that appear designed to reduce the regulatory burden on U.S. business. Earlier this year, the SEC changed the way its commissioners review cases involving potential corporate penalties. Instead of waiting until the SEC staff reaches a preliminary settlement, the change lets commissioners weigh in earlier in the process. Mr. Cox has said this will lead to faster resolutions and stiffer penalties. Some staff members fear the change may deter staff attorneys from seeking penalties.

If the move toward arbitration gathers steam, some consumer groups may worry that by curbing shareholder litigation, the nation will lose a powerful deterrent to corporate wrongdoing. Individual shareholders might also have to incur the expense of hiring a lawyer, rather than simply signing on as a member of a class.

The move would mark a significant policy shift by the SEC in its interpretation of federal securities laws. The issue is a thorny one for the SEC and could come down to how it reconciles arbitration with provisions in securities laws that protect the right of shareholders to sue. In a case related to the brokerage industry, the Supreme Court has ruled that requiring arbitration doesn't violate the so-called antiwaiver clauses of the Securities Act of 1933 and the Securities and Exchange Act of 1934.

In 1990 the issue came up in a corporate context. A Pennsylvania-based bank sought to have a mandatory arbitration clause included in the charter of its savings-and-loan subsidiary, which it planned to take public. The SEC, under then-chairman Richard Breeden, refused to approve the registration statement because of the antiwaiver clauses, and the company dropped its initial public offering.