CAN BEHAVIORAL ECONOMICS INFORM OUR UNDERSTANDING OF SECURITIES ARBITRATION?

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I. INTRODUCTION

Since *Shearson/American Express, Inc. v. McMahon*,[1] brokerage firms routinely include predispute arbitration agreements ("PDAA" or "PDAAs") in agreements with their customers.[2] As a consequence, virtually all disputes involving customers, brokerage firms, and their registered representatives are arbitrated before the Financial Industry Regulatory Authority ("FINRA") forum.[3]

Over the years there has been debate and controversy over the fairness of mandatory securities arbitration. The securities industry trade association, the Securities Industry and Financial Markets Association ("SIFMA") asserts that securities arbitration is a faster, less expensive alternative to litigation that particularly benefits small investors.[4] The North American Securities Administrators Association ("NASAA"), in contrast, supports federal legislation to make PDAAs unenforceable in securities arbitration and, in particular, argued for the removal of the mandatory industry arbitrator on every three-person arbitration panel.[5] Some investors perceive the FINRA arbitration forum as unfair,[6] and the

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1 482 U.S. 220, 238 (1987) (holding that PDAAs are enforceable with respect to claims brought under the Securities Exchange Act of 1934).

2 A recent survey of participants in Self-Regulatory Organization ("SRO") arbitrations about their perceptions of fairness reports that of the 2,841 responses, 79.3% of survey participants (2,252) indicated that the customer agreement in their most recent dispute contained a PDAA; another 208 (7.3%) survey participants answered that the customer agreement did not contain a PDAA; 13.4% (381) of survey participants did not know or could not recall. Jill I. Gross & Barbara Black, *When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration,* J. DISP. RESOL. 349, 364 (2008) [hereinafter Gross & Black, *Empirical Study of Investors*]. In contrast, a 1981 SEC survey showed that only 39% of cash accounts required a PDAA. Barbara Black & Jill I. Gross, *Making It Up As They Go Along: The Role of Law In Securities Arbitration,* 23 CARDOZO L. REV. 991, 1002 n. 70 (2002) [hereinafter Black & Gross, *Making It Up*].

3 FINRA is the SRO for all U.S. broker-dealers and operates the largest dispute resolution forum in the securities industry. *Arbitration and Mediation*, FINRA, http://www.finra.org/ArbitrationMediation/index.htm (last visited Feb. 9, 2011).

4 *Industry Perspectives on the Obama Administration's Financial Regulatory Reform Proposals: Hearing Before the House Comm. on Fin. Serv.*, 111th Cong. 114 (2009), (Statement of Randolph C. Snook, Executive Vice President, Sec. Indus. & Fin. Mkts. Ass'n), *available at* http://www.house.gov/ apps/list/hearing/financialsvcs_dem/62.pdf.

5 *Pro-Investor Legislative Agenda for the 111th Congress*, NASAA (Jan. 2009), http://www.nasaa.org/ issues___answers/legislative_activity/10147.cfm. *See infra* notes 16-22 and accompanying text.

financial media coverage of the process is generally negative.[7] Finally, many academics who have studied the FINRA arbitration forum award it high marks for meeting most generally recognized standards of fairness,[8] although some (including this author) also called for the elimination of the mandatory industry arbitrator.[9]

Even as the Supreme Court pursues its strong pro-arbitration policy,[10] Congress has expressed reservations about the fairness of consumer and employment arbitration. It has held hearings and seriously considered, but has not to date enacted, the Arbitration Fairness Act of 2009 that would have prohibited consumer PDAAs (including securities arbitration).[11] The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[12] evidences continuing congressional concern over arbitration. Dodd-Frank gives the Securities and Exchange Commission ("SEC") the authority to ban use of PDAAs with respect to federal securities claims and claims based on Self-Regulatory Organization (SRO") rules[13] and requires the Government Accountability Office to study SRO arbitration services.[14] The statute also gives the Consumer Financial Protection Bureau authority to regulate "consumer financial product[s] or service[s],"[15] which may extend to brokerage margin agreements.

Perhaps in response to Dodd-Frank, in November 2010, FINRA filed a rule proposal with the SEC that would allow all investors the option of having an all-public

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[6] *See* Gross & Black, *Empirical Study of Investors*, *supra* note 2, at 389-391.

[7] *Id.* at 397.

[8] *See* Barbara Black, *Is Securities Arbitration Fair to Investors?*, 25 PACE L. REV. 1, 5-6 (2004) [hereinafter Black, *Is Securities Arbitration Fair?*]; Jill I. Gross, *McMahon Turns Twenty: The Regulation of Fairness in Securities Arbitration,* 76 U. CIN. L. REV. 493, 517-18 (2008) [hereinafter Gross, *McMahon Turns Twenty*]; *see also* MICHAEL PERINO, REPORT TO THE SECURITIES AND EXCHANGE COMMISSION REGARDING ARBITRATOR CONFLICT DISCLOSURE REQUIREMENTS IN NASD AND NYSE SECURITIES ARBITRATIONS 37 (Nov. 4, 2002), *available at* http://www.sec.gov/pdf/arbconflict.pdf (recognizing "lingering concerns" about pro-industry bias). For a more critical view, *see generally* Edward Brunet & Jennifer J. Johnson, *Substantive Fairness in Securities Arbitration,* 76 U. CINN. L. REV. 459 (2008) (arguing that fairness in securities arbitration requires procedures that apply substantive legal principles).

[9] Gross & Black, *Empirical Study of Investors*, *supra* note 2, at 400. *See infra* notes 16-22 and accompanying text.

[10] Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1 (1983). Since *Moses H. Cone Mem'l Hosp.*, the Supreme Court has consistently interpreted the Federal Arbitration Act (FAA) as setting forth a "liberal federal policy favoring arbitration agreements." *Id.* at 24.

[11] *Proposed Arbitration Fairness Act of 2009*, S. 931, 111th Cong. § 402 (2009); H.R. 1020, 111th Cong. § 4 (2009).

[12] The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified in scattered sections and titles of U.S.C.).

[13] *Id.* at § 921. The statute does not require the SEC to take any action. Even prior to Dodd-Frank, the SEC's Investor Advisory Committee has been studying the SRO arbitration process. *See, e.g.,* SEC, Open Meeting of the SEC Investor Advisory Committee (May 17, 2010) (discussion with experts' panel on mandatory arbitration), http://www.sec.gov/news/otherwebcasts/2010/ iacmeeting051710.shtml. Section 921, however, does not give the SEC the authority to ban the use of PDAAs with respect to state law claims, so an SEC prohibition would essentially return the law to the pre-*Shearson* bifurcation of claims principles set forth in Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213 (1985).

[14] Dodd-Frank, at § 964.

[15] *Id.* at § 1028(b).

arbitration panel.[16] In making the announcement, FINRA's Chairman and CEO Richard Ketchum stated that this was being done to "enhance confidence in and increase the perception of fairness in the FINRA arbitration process."[17] The SEC received 125 comments on the proposal, virtually all of which substantially supported it.[18] SIFMA, which has defended the inclusion of an industry arbitrator on three-person arbitration panels,[19] opposed applying the proposed rule change to individually named registered representatives.[20] On January 31, 2011 (after a remarkably short approval process), the SEC approved the proposed rule change because it believed it "should help enhance public confidence in, and perception of, the fairness of the FINRA arbitration forum."[21] The customers' option of an all-public arbitrator panel went into effect on February 1, 2011.[22]

The public arbitrator proposal, however, does not address the more fundamental question about the fairness of mandatory arbitration. In light of the criticisms and investor dissatisfaction with the process, it is perplexing that there is not more investor resistance to opening brokerage accounts with firms whose customer agreements contain a PDAA. Why have not some brokerage firms competed for business by offering account agreements without a PDAA? This paper contributes to the ongoing debate over FINRA arbitration by invoking behavioral economics principles to understand why PDAAs in securities arbitration continue to resist powerful market and political forces calling for their elimination.

Part II of the paper sets forth background information to put the issue in context. It first describes several important distinctions between securities arbitration and other forms of consumer arbitration. It next summarizes pertinent economic theory, first classical economic theory in support of PDAAs and then behavioral economics principles that challenge the classical approach.

Part III poses three questions regarding the staying power of PDAAs and explores whether classical or behavioral economics theory can help answer them:

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[16] Amendments to the Panel Composition Rule, and Related Rules, of the Code of Arbitration Procedure for Customer Disputes, Exchange Act Release No. 34-63250, 75 Fed. Reg. 69481-01 (Proposed Nov. 12, 2010), *available at* http://www.gpo.gov/fdsys/pkg/FR-2010-11-12/pdf/2010-28419.pdf. In 2008, FINRA instituted a pilot program with a number of brokerage firms that gave eligible investors the option of selecting an all-public arbitrator panel. *Id.*

[17] *FINRA Proposes to Permanently Give Investors the Option of All-Public Arbitration Panels*, FINRA (Sept. 28, 2010), http://www.finra.org/Newsroom/NewsReleases/2010/P122178.

[18] Specifically, there were 103 in support of the proposal, 21 in support of the proposal with modifications, and one opposing the proposal. Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change Relating to Amendments to the Panel Composition Rule, and Related Rules, of the Code of Arbitration Procedure for Customer Disputes, Release No. 34-63799, 76 Fed. Reg. 6500 (Feb. 4, 2011) [hereinafter SEC Approval].

[19] SIFMA, WHITE PAPER ON ARBITRATION IN THE SECURITIES INDUSTRY 36-37 (Oct. 2007), *available at* http://www.sifma.org/issues/item.aspx?id=21334 [hereinafter SIFMA WHITE PAPER].

[20] SEC Approval, *supra* note 18, at 6502.

[21] *Id.*

[22] FINRA Reg. Notice 11-05, *Customer Option to Choice an All-Public Arbitration Panel in All Cases,* (Feb. 2011), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122879.pdf.

Question One. What do customers of brokerage firms gain by agreeing to PDAAs, since they always have the right to settle disputes with their firm or registered representative through FINRA arbitration?

Question Two. If at least some investors, at the time they enter their relationship with a brokerage firm, would like a choice of arbitrating or litigating, why does the market place not meet this demand?

Question Three. If at least some investors, after a bad experience in arbitration, want the right to litigate future disputes, why does the market place not meet this demand?

Part III concludes that behavioral economics supports regulation of PDAAs in securities arbitration to assure fairness.

Part IV poses a fourth question related to the policy implications of the preceding behavioral economics analysis: What would happen if the SEC or Congress prohibited PDAAs in customers' agreements? I conclude that if Congress or the SEC prohibits PDAAs in securities arbitration, the effect on the FINRA arbitration forum may not be beneficial to investors with small dollar value claims.

II. LAYING THE FOUNDATION

A. Securities Arbitration in the FINRA Forum

The financial services industry is a heterogeneous industry, with many different kinds of firms offering a variety of products and services.[23] Accordingly, it is expected that competition would flourish and brokerage firms would be eager to offer terms that would attract a significant number of customers. The broker-dealer industry is also a highly regulated industry; the pervasive regulatory power of FINRA, as an SRO under SEC oversight, affects virtually every aspect of the business. Thus, the brokerage industry is both highly competitive and highly regulated.

FINRA securities arbitration shares characteristics with other types of consumer arbitration, principally because most retail investors sign standard form, take-it-or-leave-it contracts that are virtually identical across the brokerage industry. FINRA securities arbitration, however, has characteristics that make it different from other types of consumer arbitration. First, unlike their relationships with credit card companies and computer manufacturers, many investors have personal relationships with their registered representatives that encourage trust.[24] Second, again unlike many other forms of consumer arbitration,[25] customers actually sign agreements that contain the PDAA when they enter a relationship with their brokerage firms.[26] Third, FINRA, subject to SEC oversight, regulates

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[23] ANGELA A. HUNG ET AL., INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS 36 (2008) [hereinafter RAND STUDY]. The financial services industry includes not only broker-dealers, but also investment advisers that compete for investors' business. In this paper I focus only on PDAAs offered by broker-dealers, as investment advisers are not regulated by FINRA.

[24] RAND Study, *supra* note 23, at 107 (investors stated the importance of trust of the individual financial service professional).

[25] *See* Hill v. Gateway 2000, 105 F.3d 1147 (7th Cir. 1997) (holding that consumer-buyer was bound by arbitration clause within the box the computer was shipped in).

[26] Within 30 days of signing, a copy of the agreement containing a PDAA must be given to the customer who shall acknowledge receipt in writing. NASD R. 3110(f)(2)(B) (2006).

the terms of the PDAA by requiring certain disclosures.[27] FINRA also prohibits many of the unfair practices found in other types of consumer arbitration. PDAAs cannot limit the availability of any remedy, including punitive damages,[28] investors maintain the right to bring class actions in court,[29] and the site of the hearing is determined by the investor's residence.[30] Finally, under FINRA Rule 12200, customers always have the right to compel arbitration of disputes with their brokerage firms and registered representatives; the firm cannot contract out of this commitment.[31] A version of FINRA Rule 12200 has been included in the FINRA (and its predecessors) customer arbitration code since 1972.[32] There has been virtually no discussion of its rationale beyond investor protection.[33]

B. Economic Theory

I first summarize classical economic theory that generally supports the use of PDAAs. I then introduce pertinent behavioral economics principles that call into question certain aspects of the classical theory.

1. Classical Economic Theory

Steven Shavell and Keith Hylton have written elegant explanations of classical economic theory that assumes parties take rational account of the effects of alternate dispute resolution on the likely disposition of their disputes and adopt PDAAs whenever the agreements mutually benefit the parties.[34] Parties have an incentive to enter into PDAAs when the margin between the deterrence benefit and expected total litigation cost is greater under the arbitration system.[35] A party that benefits from arbitration may have to make a side payment to the party that is disadvantaged by the arbitration forum.[36] Professor Hylton acknowledges that informational asymmetries can undercut the contractual theory.[37] Parties,

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[27] The PDAA must be highlighted and be immediately preceded by required language that highlights differences between arbitration and litigation and also incorporates by reference the current and future rules of the arbitration forum. NASD R. 3110(f)(1) (2006). In addition, there must be a highlighted statement immediately preceding the signature line that states the agreement contains a PDAA and indicates its location in the document. NASD R. 3110(f)(2)(A) (2006).

[28] NASD R. 3110(f)(4) (2006). In addition, no PDAA may include any condition that limits or contradicts the rules of any SRO. *Id.*

[29] FINRA R. 12204(d) (2008).

[30] FINRA R. 12213(a) (2008).

[31] FINRA R. 12200 (2010).

[32] SIFMA WHITE PAPER, *supra* note 19, at 2 n. 6. *See also* Axelrod & Co. v. Kordich, 451 F.2d 838 (2d Cir. 1971) (the Second Circuit rejected a NYSE member firm's challenge to the NYSE's version of the rule in a dispute with a non-member firm).

[33] *See* Scobee Combs Funeral Home, Inc. v. E.F. Hutton & Co., 711 F. Supp. 605, 607 (S.D.Fla. 1989).

[34] Keith N. Hylton, *Agreements to Waive or to Arbitrate Legal Claims: An Economic Analysis*, 8 SUP. CT. ECON. REV. 209, 213 (2000); Steven Shavell, *Alternative Dispute Resolution: An Economic Analysis*, 24 J. LEGAL STUD. 1, 2 (1995).

[35] Hylton, *supra* note 34, at 213. In addition, there may be other benefits from arbitration, such as engendering superior incentives through greater accuracy of the result, and improving incentives to engage in disputes or refrain from them. Shavell, *supra* note 34, at 2.

[36] Hylton, *supra* note 34, at 223.

[37] *Id.* at 214.

however, may not be as naïve as sometimes supposed,[38] and uninformed parties may act rationally if the costs of obtaining information are higher than perceived benefits.[39] In short, both Professor Shavell and Professor Hylton assert that the legal system should ordinarily enforce PDAAs because they are knowingly and voluntarily agreed to as part of the bargain,[40] although Professor Hylton recognizes that satisfaction of a "knowing and voluntary" standard may require special notice of the existence and meaning of an arbitration clause.[41] Finally, under classical economic theory, there is generally no reason for the state to favor PDAAs.[42]

In contrast, critics of mandatory consumer arbitration, such as Jean Sternlight, believe that, as a practical reality, consumers cannot bargain over PDAAs and have little choice but to accept the terms contained in the standard form contracts used by businesses.[43] According to these critics, enforcement of PDAAs deprives consumers of their access to court on an involuntary and unknowing basis.[44] In addition, as developed further below, some scholars, relying on behavioral economics literature, assert that consumers typically are not as rational as classical economic theory supposes.[45]

2. Behavioral Economics

Behavioral law and economics seeks to improve the predictive power of classical economic theory by incorporating more realistic accounts of actors' behavior.[46] Behavioral economics identifies certain limits on cognition common to contracting parties.[47] These limits on cognition may help to explain investors' relationships with their investment advice providers and, specifically, their failure to negotiate about dispute resolution alternatives when selecting their investment advice providers.

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[38] *Id.* at 239-40.

[39] *Id.* at 252.

[40] Hylton, *supra* note 34, at 212-13, Shavell, *supra* note 34, at 3.

[41] Hylton*, supra* note 34, at 260. FINRA requires special notice of the PDAA in customers' agreements. *See supra* note 27 and accompanying text. The Supreme Court struck down a state law that required special notice of an arbitration clause, finding that it was preempted by the Federal Arbitration Act (FAA). *See* Doctor's Assocs., Inc. v. Cassarotto, 517 U.S. 681 (1996). An unexplored issue is whether Rule 3110(f) reflects an anti-arbitration bias that conflicts with *Casarotto*, and, if so, whether SEC oversight under the Securities Exchange Act prevails over the FAA. *See* Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 226-27 (1987) (discussing "implied repeal").

[42] Shavell, *supra* note 34, at 4.

[43] *See, e.g.,* Jean R. Sternlight, *Consumer Arbitration in* ARBITRATION LAW IN AMERICA: A CRITICAL ASSESSMENT §5.3(1) (Edward Brunet et al. eds., 2006).

[44] *Id.* at § 5.3(2)(A).

[45] *See* Russell Korobkin, *Bounded Rationality, Standard Form Contracts and Unconscionability,* 70 U. CHI. L. REV. 1203 (2003) (arguing that because of bounded rationality buyers take into account only a limited number of product attributes).

[46] Christine Jolls, *Behavioral Law and Economics in* BEHAVIORAL ECONOMICS AND ITS APPLICATIONS 116 (Peter Diamond & Hannu Vartiainen eds., 2007).

[47] Melvin Eisenberg, *The Limits of Cognition and the Limits of Contract,* 47 STAN. L. REV. 211, 213-25 (1995). For an excellent introduction to these concepts, *see* Christine Jolls, Cass R. Sunstein & Richard H. Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998).

Bounded rationality. People have "limited computational skills and seriously flawed memories" that result in predictable mistakes.[48] Because of cognitive limitations, individuals must resort to heuristics, or shortcuts, that result in judgment errors that can distort the way an actor searches for, processes, and weighs information and alternatives. These include:

- *Over-optimism and over-confidence*. Over-optimism, a common judgment error, leads people to think that they have better-than-average skills and abilities and that bad things are less likely to happen to them than to other people.[49] People generally "believe they will experience more good outcomes and fewer bad outcomes than similar others."[50] When entering into contracts or relationships, people typically underestimate the likelihood of disappointing results and failure.[51]

- *Status quo bias (endowment effect)*. The status quo bias, the endowment effect, and more generally, loss aversion explain why, contrary to classical economic theory, people generally weight losses more heavily than gains in bargaining. As a result, the assignment of default terms can affect the outcomes of bargaining even if transaction costs are low.[52] Individuals generally want to maintain the status quo rather than change their behavior or situation.[53] As a result, they frequently place a higher value on something once they own it.[54] Contracting parties may consider default terms in contracts as the status quo and be reluctant to negotiate for substitute terms.[55]

- *Self-serving bias*. The self-serving bias is described as the tendency of individuals to assess fairness based on their self-interest.[56] As a result of the self-serving bias, parties may not be able to accept adverse decisions or even compromises. For example, a frequently-cited study found that teachers' contract negotiations over salary increases reached an impasse because the teachers and the school districts had different assessments of comparable school districts.[57]

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[48] Jolls et al., *supra* note 47, at 1477.

[49] Eisenberg, *supra* note 47, at 216-18; Jolls et al., *supra* note 47, at 1524.

[50] Barbara Mellers & A. Peter McGraw, *Self-serving Beliefs and the Pleasure of Outcomes, in* II THE PSYCHOLOGY OF ECONOMIC DECISIONS 31(Isabelle Brocas & Juan D. Carillo eds., 2004).

[51] Jolls et al., *supra* note 47, at 1541-42.

[52] *Id.* at 1498.

[53] JOHN MALCOLM DOWLING & YAP CHIN-FANG, MODERN DEVELOPMENTS IN BEHAVIORAL ECONOMICS 63 (2007).

[54] BRUCE E. KAUFMAN, *Integrating Emotions into Economic Theory in* HANDBOOK OF CONTEMPORARY BEHAVIORAL ECONOMICS 88 (Morris Altman ed., 2006).

[55] Russell Korobkin, *Status Quo Bias and Contract Default Rules,* 83 CORNELL L. REV. 608, 612 (1998).

[56] Jolls et al., *supra* note 47, at 1501.

[57] *Id.* at 1502.

Accordingly, because of bounded rationality, people may use these common heuristics and unintentionally make judgment errors. In addition, individuals may intentionally decide to ignore some information. Because of the costs to acquire information, people will resort to *rational ignorance* or "strategic ignorance."[58] In comparing products and services, people understand the problem of diminishing returns; at some point, the costs of the search and the processing of the information will exceed the expected utility of the additional information.[59] Actors thus normally do not try to make optimal substantive decisions, but satisfactory ones.[60] While the necessity to limit information is a rational response to facilitate decision-making, an individual may, because of the previously identified judgment errors, have faulty perceptions about the pertinence of some types of information. Hence, bounded rationality and rational ignorance may work in tandem to produce faulty decision-making.

The academic literature has explored in depth the opposing positions of classical economic theory, on the one hand, and behavioral economics principles, on the other, in the debate over the fairness of PDAAs in consumer and employment arbitration,[61] although more empirical research is needed.[62] Part III applies the theory in the specific factual context of FINRA securities arbitration where the academic literature has not applied the competing classical economic and behavioral economic theories. In addition, empirical data about investors' decision-making and the FINRA process allow for a more realistic assessment.

III. THREE QUESTIONS: APPLYING THE THEORY TO SECURITIES ARBITRATION

Question One. What do customers of brokerage firms gain by agreeing to PDAAs, since they always have the right to settle disputes with their firm or registered representative through FINRA arbitration?

Under classical economic theory,[63] the answer to this question is simple. Brokerage firms would have to offer investors a side payment to give up their right to litigate. It is

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[58] Isabelle Brocas et al., *Commitment Devices in* II THE PSYCHOLOGY OF ECONOMIC DECISIONS 54 (Isabelle Brocas & Juan D. Carillo eds., 2004).

[59] *See* Shawn J. Bayern, *Rational Ignorance, Rational Close-Mindedness, and Modern Economic Formalism in Contract Law,* 97 CAL. L. REV. 943, 947 (2009).

[60] Eisenberg, *supra* note 47, at 214.

[61] *See* Daniel B. Klaff, *Debiasing and Bidirectional Bias: Cognitive Failure in Mandatory Employment Arbitration,* 15 HARV. NEGOT. L. REV . 1 (2010) (discussing behavioral economic concepts in employment PDAAs); Matthew T. Bodie, *Questions About the Efficiency of Employment Arbitration Agreements,* 39 GA. L. REV. 1, 31-39 (2004) (applying a number of heuristics to an employee's decision to accept an employment PDAA); Korobkin, *supra* note 45 (arguing that because of bounded rationality sellers consider only salient terms of standard form contracts).

[62] Sternlight, *supra* note 43, at § 5.4 (discussing the available studies and the difficulties of empirical research); *see also* Amy J. Schmitz, *Legislating in the Light: Considering Empirical Data in Crafting Arbitration Reforms,* 15 HARV. NEGOT. L. REV. 115 (2010) (discussing the available empirical data on consumer contracting with respect to PDAAs); Joshua D. Wright, *Behavioral Law and Economics, Paternalism, and Consumer Contracts: An Empirical Perspective,* 2 NYU J.L. & LIBERTY 470 (2007) (concluding that empirical studies of firm and consumer behavior do not support the claims that behavioral law and economics generates greater predictive power than conventional price theory).

[63] Hylton, *supra* note 34, at 213; Shavell, *supra* note 34, at 2.

possible that firms offer investors lower commissions because of their ability to reduce litigation costs through PDAAs. To my knowledge, there are no empirical studies that address this issue. The brokerage industry's robust defense of PDAAs suggests that the industry believes PDAAs reduce its costs.[64] Classical economic theory, however, does not fully explain the universality of PDAAs.

Question Two. If at least some investors, at the time they enter their relationship with a brokerage firm, would like a choice of arbitrating or litigating, why does the market place not meet this demand?

In the entire universe of investors, there may well be some investors that want a choice and would be willing to pay for it; if so, one would expect some firms to offer to drop the PDAA in exchange for higher commissions. Why has this not happened? Here, we turn to behavioral economics to provide insight.

Critics of mandatory arbitration often state that individuals are unaware of the existence of a PDAA in a standard form contract.[65] It is likely, however, that most investors are aware of the PDAA at the time they enter their brokerage relationship. In a survey which I co-authored, many customers stated that they were aware of the PDAA before their dispute with their brokerage firm arose.[66] The financial press frequently writes about securities arbitration and PDAAs.[67] Finally, FINRA rules require the highlighting of the PDAA in the agreement[68] (although I discount the importance of this factor, given the length and complexity of most customers' agreements). Accordingly, this is not the same situation as when the credit card company or the computer manufacturer buries an obscurely written PDAA in the fine print of a document that does not bear much resemblance to a contract and that does not require the consumer's signature. So ignorance of the PDAA is not likely the explanation for investors' acquiescence.

Investment decisions, however, including the choice of a financial service professional, involve consideration of a great deal of complicated and technical information likely to confuse many investors. For example, investors report that they are confused about the titles, duties, and fees of different types of financial services professionals.[69] Investors also have to face decisions about the various types of investment products available to them and their suitability for their investment needs.[70] In this jumble of information,[71] it is unlikely that the investor would invest much time to consider the costs and benefits of a

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[64] I am grateful to Professor Stephen Ware for his comments on this point.

[65] Sternlight, *supra* note 43, at § 5.3(1).

[66] 63.29% of survey participants who answered this question and identified themselves as customers (692 responses) were aware of the PDAA before the dispute arose, while 36.71% of customers were not aware. Gross & Black, *Empirical Studies of Investors*, *supra* note 2, at 364.

[67] *Id.*

[68] *See supra* note 27.

[69] RAND Study, *supra* note 23, at 112.

[70] *Id.* at 84 (concluding that investors would have difficulty understanding key aspects of the prospective relationship with investment advice providers based on disclosure documents and web sites).

[71] *Id.* at 107 (stating that focus group participants report getting information about financial products and services from a variety of sources).

PDAA. Bounded rationality explains why investors might only consider the most important aspects of the relationship offered by the brokerage firm; they will have to resort to rational ignorance and rely on their investment advice provider for the rest.[72] It is unlikely that the registered representative would devote time to explaining the PDAA. Besides the fact that a PDAA does not lend itself to the kind of sales talk brokers engage in to win over new customers, the over-optimism bias also explains why investors and brokers alike are not likely to focus on a PDAA; the parties expect their relationship to be a successful one. Investors select a brokerage firm in many instances because they trust the registered representative and expect that their relationship will be successful.[73] Thus, it is unlikely that investors are focusing on possible broker-dealer misconduct when they enter a brokerage relationship.

There is also another compelling argument in support of rational ignorance as the explanation for why PDAAs are virtually universal. Even if the investor thought about the PDAA, she may not be able to predict ex ante whether litigation or arbitration would be a better forum for her potential claim. Some critics of consumer arbitration assume that consumers will always have a better chance of prevailing in court than in arbitration.[74] That is emphatically not the case for investors; the choice of the optimal forum for investors is more complicated. Consider two investors. A is a disabled senior citizen with a large investment portfolio, whose registered representative engaged in blatant fraud that resulted in large losses. B, in contrast, is an investor with a small portfolio, whose registered representative made an unsuitable recommendation that resulted in losses that, while significant to B, would not be considered a sizable claim. Ex post, A is likely to prefer litigation: she is a plaintiff that a jury would sympathize with, thus increasing the likelihood of a sizable damages judgment, including punitive damages, and the firm will want to avoid a jury and the bad publicity of a trial. B, ex post, is likely to prefer arbitration: the small amount of her claim makes litigation too expensive as an option, and many courts do not recognize a claim based on a violation of the FINRA suitability rule.[75] Ex ante, however, the choice between arbitration and litigation may be less clear for both investors. If A's losses were not substantial or if the loss resulted from a breach of the FINRA suitability rule, A might prefer arbitration. B is more likely to prefer arbitration ex ante, because the small size of her portfolio will likely make any claim not cost-effective in litigation, although B may have reason to believe that in time the size of her portfolio will increase (if, for example, she expects a large inheritance in the future). In short, rational ignorance is a sensible choice given the uncertainties.

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[72] *Id.* at 88, 131 (reporting industry perceptions that investors rarely read disclosure documents and rely on their financial services professional).

[73] *Id.* at 107 (investors stated the importance in trusting the individual financial service professional).

[74] *See* Sternlight, *supra* note 43, at § 5.3(2).

[75] *See, e.g.,* Minneapolis Employees Ret. Fund v. Allison-Williams Co., 519 N.W.2d 176, 182 (Minn. 1994) (holding that state suitability regulation did not provide a customer with a remedy). FINRA arbitration rules do not require investors to state a legal claim; the claimant need only file a "statement of claim specifying the relevant facts and remedies requested." FINRA R. 12302 (2008), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4124.

Russell Korobkin's analysis of bounded rationality in the context of standard form contracts has particular relevance to customers' brokerage agreements.[76] Professor Korobkin's approach is to determine whether the contract term is salient or non-salient to a significant number of buyers.[77] A term is salient if it is evaluated, compared, and implicitly priced as part of the purchase decision.[78] When a term is non-salient to most buyers, he argues that the market check on seller overreaching is absent.[79] Accordingly, legislatures should mandate efficient non-salient terms ex ante, and courts should police them ex post for inefficiency.

In the context of brokerage relationships, investors consistently identify trust as the most important factor in the relationship,[80] and brokerage firms advertise heavily on the basis of trust.[81] Many brokerage firms, in particular discount and online firms, advertise on the basis of low commissions,[82] so that all firms face competitive pressures to keep commissions low. Trust and commissions thus are salient terms, while PDAAs, for the reasons discussed above, are not. In addition, because regulatory and compliance requirements for the protection of investors increase firms' costs of doing business, if firms achieve savings from PDAAs, they have good reason to resist competition on the basis of PDAAs; cost savings depend on keeping the term non-salient.

The status quo bias further explains why investors may not consider the implications of a PDAA. Because securities arbitration is often described as "mandatory," investors may not understand it results from a contract term that could be altered. It is also unlikely that most investors understand that they already have a right to arbitrate outside of the contract, so the PDAA is entirely for the benefit of the firm.[83]

Accordingly, even though investors may know about PDAAs, rational ignorance, over-optimism, and the status quo bias help explain why the PDAA is likely not a salient term, at least at the time of the initial contract. Thus, behavioral economics may explain why investors, when they first enter into a brokerage relationship, do not negotiate over the PDAA.

Question Three. If at least some investors, after a bad experience in arbitration, want the right to litigate future disputes, why does the market place not meet this demand?

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[76] Korobkin, *supra* note 45; George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism,* 84 Q. J. ECON. 488 (1970), is an early influential article that explores the ability of poor-quality terms to drive out better-quality terms. *See also* Melvin Eisenberg, *The Limits of Cognition and the Limits of Contract,* 47 STAN. L. REV. 211, 244 (1995). Daniel Farber makes similar arguments with respect to warranties. *Contract Law and Economic Theory,* 78 NW. U. L. REV. 303 (1983).

[77] Korobkin, *supra* note 45, at 1225.

[78] *Id.*

[79] *Id.*

[80] RAND Study, *supra* note 23, at 120 (investors stated the importance of trust of the individual financial service professional).

[81] *Id.* at 123.

[82] *Id.* at 16 (describing growth of discount brokerage programs).

[83] *See supra* note 31 and accompanying text.

I have now explained why the PDAA may not initially be an important term for investors. But could not the PDAA assume importance to those investors that experienced a disappointing result in arbitration? There is some empirical evidence that such investors exist. Participants in the survey of FINRA arbitration were asked if, based on their experiences in one or more customer arbitrations, they would choose arbitration to resolve a customer dispute in the future. Of 1,359 customer responses, 24.65% said they would, while 35% said they would not choose arbitration because it is unfair; another 26% were not sure.[84]

Because of the small number of customers who answered these questions, these responses are of limited utility,[85] except to support the perhaps obvious point that people prefer choice and that after a bad experience with arbitration, investors may think that litigation must be a better alternative. The self-serving bias, moreover, could also exacerbate an investor's perception that an arbitration result was unfair in instances where the investor did not receive full recovery for her losses.[86] Whether or not these perceptions are accurate, they could instill a desire in some investors to search for firms that do not require PDAAs. Yet there is no evidence that this has happened.

Professor Korobkin is doubtful that a term that is initially non-salient can later become salient, citing the likely small number of defections and the seller's disinclination to retain troublesome buyers.[87] Brokerage firms may be unwilling to drop PDAAs because of their significant investment in the FINRA process or because they have achieved significant savings through FINRA arbitration. Moreover, brokerage firms likely do not see "you can sue us" as an attractive ad campaign. I do not find Professor Korobkin's explanation entirely convincing because it discounts the significance that new information or insights might bring to bear on subsequent bargains.[88] Nevertheless, in the case of brokerage PDAAs, market realities support Professor Korobkin's view that non-salient terms will not often subsequently become salient.

IV. FORECASTING THE FUTURE OF FINRA SECURITIES ARBITRATION

Question Four. What would happen if the SEC or Congress prohibited PDAAs in securities arbitration?

Dodd-Frank gives the SEC authority to prohibit PDAAs but only with respect to claims arising under federal securities laws and SRO rules.[89] If the SEC exercised its authority, brokerage firms could still enforce PDAAs with respect to state law claims. This

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[84] Gross & Black, *Empirical Studies of Investors*, *supra* note 2, at 379-80.

[85] *Id.* at 387.

[86] From 2005-2010, the percentage of cases that proceeded through the award stage in which customers obtained a monetary recovery ranged from 37 to 47%. FINRA, Dispute Resolution Statistics, Results of Customer Claimant Arbitration Award Cases, http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/index.htm.

[87] Korobkin, *supra* note 45, at 1240-41.

[88] *See* Jonathan Klick, *The Microfoundations of Standard Form Contracts: Price Discrimination vs. Behavioral Bias,* 32 FLA. ST. U. L. REV. 555, 562 (2005) (criticizing Korobkin on this point).

[89] The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), Pub. L. No. 111-203, 124 Stat. 1376, at § 921 (2010) (to be codified in scattered sections and titles of U.S.C.).

was the state of the law pre-*Shearson*[90] when, to determine the arbitrability of customers' claims, courts were required to categorize the claims as federal or state, so that state claims could proceed to arbitration and federal claims could proceed to court.[91] This bifurcation of claims was based on a fundamental misconception of securities arbitration, since claimants are not required to frame their disputes as legal claims.[92] The doctrine was also inefficient since it could lead to dual-track proceedings.[93] It is unlikely that the SEC would want to revive the bifurcation doctrine and its resulting inefficiencies. In addition, because Dodd-Frank mandates so many rulemaking initiatives and studies by the SEC, the agency has little time and resources to devote to other initiatives in the immediate future. Accordingly, I predict that the SEC will not exercise its authority under Dodd-Frank.

Congress, however, recently considered legislation to prohibit the use of PDAAs in consumer and employment arbitration[94] and, if the SEC fails to act, may choose to revisit the issue. Unlike the SEC, Congress has the authority to enact legislation prohibiting PDAAs in all securities arbitrations. Accordingly, it is a useful thought exercise to forecast the consequences if Congress determines to prohibit PDAAs in securities arbitration.

Critics of mandatory securities arbitration frequently assert that, if the FINRA arbitration forum is perceived as fair, PDAAs are not necessary because the parties will agree post-dispute to arbitrate— and, if the forum is not perceived as fair, investors should not be forced to arbitrate.[95] While this argument is superficially plausible, it does not hold up upon analysis, because it fails to take into account that after the dispute has arisen, the parties will have strategic considerations to favor one forum over the other. Consider, for example, the previously described investors A and B.[96] A, a sympathetic plaintiff with a large claim based on blatant broker fraud, will want to litigate her claim before a sympathetic jury, while B, with a small claim based on the broker's breach of the FINRA suitability rule, will want to arbitrate her claim. The broker's strategic choice is exactly the opposite; it will not want A's claim to go to court, with the attendant risk of high liability and unfavorable publicity, while it is to its advantage if B is forced to bring her claim in court, because the costs of litigation, as well as the lack of strong legal basis for the claim (at least in some states), make a judicial proceeding infeasible. Studies of employment arbitration confirm that post-dispute arbitration agreements are rare.[97]

If Congress prohibited PDAAs, so long as FINRA Rule 12200[98] remains in effect, customers would have a choice of arbitrating or litigating their disputes. Accordingly,

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[90] Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 238 (1987).

[91] Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213 (1985).

[92] *See supra* note 75.

[93] Byrd, 470 U.S. at 221 (acknowledging that "piecemeal" litigation could result in inefficiencies).

[94] *Proposed Arbitration Fairness Act of 2009*, S. 931, 111th Cong. § 402 (2009); H.R. 1020, 111th Cong. § 4 (2009).

[95] Patricia Struck, President, N. Am. Sec.s Admin. Ass'n, President's Remarks at the 2005 Annual Conference (Sept. 13, 2005), *available at* http://www.nasaa.org/NASAA_ Newsroom/Speeches/3624.cfm (stating that "NASD should consider ways to make arbitration truly voluntary").

[96] *See supra* notes 74-75 and accompanying text (discussion of A and B).

[97] *See* Peter B. Rutledge, *Whither Arbitration?*, GEO. J. L. & PUB. POL'Y, 549, 587 (2008) (describing empirical data).

[98] *See supra* note 31 and accompanying text.

investors whose claims would likely fare better in arbitration, like investor B, would invoke their right to pursue arbitration. As a result, the FINRA forum could be transformed to a small claims forum. FINRA's revised mission would be to maintain a securities arbitration forum for small investors and small claims, which was, in fact, the SEC's original vision of SRO securities arbitration.[99]

The securities industry is currently the biggest cheerleader for FINRA arbitration. The subtitle of its 2007 White Paper summarizes SIFMA's message: "the success story of an investor protection focused institution that has delivered timely, cost-effective, and fair results for over 30 years."[100] The industry fought hard for *Shearson* and the right to enforce PDAAs with respect to federal securities claims, in large part because it expected that arbitration would reduce its exposure to large damages claims. At that time New York law, the choice of law selected in many PDAAs, did not permit arbitrators to award punitive damages.[101] Although *Mastrobuono v. Shearson Lehman Hutton Inc.*[102] subsequently held that punitive damages could be awarded in securities arbitration, industry support for arbitration remained steadfast, presumably because it still realizes cost savings both in terms of the amounts paid on claims and the costs of defending claims. If these cost savings are reduced, because investors will be able to litigate the big-ticket claims, the industry may give up its support for FINRA securities arbitration.

Would it matter if FINRA arbitration loses the support of the industry? There would be a financial impact. Although dispute resolution fees are not one of the principal sources of revenue for FINRA, accounting for less than ten percent of FINRA's total operating revenues,[103] a significant decrease in fees collected could necessitate cutbacks in service and personnel devoted to dispute resolution. In recent years FINRA has initiated major reforms to the arbitration process that might not be possible in the era of a downsized forum, and it may be hard pressed to continue to devote substantial resources for enhancements and improvements to the forum in the absence of industry support, financial and otherwise.

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[99] SEC originally contemplated a small claims arbitration procedure, while investors with large claims would litigate their claims. *See* Black & Gross, *Making It Up, supra* note 2, at 998. In that context the SEC, summarizing comments made by participants at a forum, stated:

> There was agreement among all commentators and witnesses that the securities industry has an obligation to respond to investor complaints, and that disputes should be resolved as quickly as possible. In general, commentators agreed that the securities industry and the self-regulatory organizations should be responsible for improving dispute resolution programs, since government intervention could be costly and unproductive.

Implementation of an Investor Dispute Resolution System, Exchange Act Release No. 34-13470, 1977 WL 175430, at *2 (April 26, 1977).

[100] SIFMA WHITE PAPER, *supra* note 19.

[101] *See* Garrity v. Lyle Stuart, Inc., 40 N.Y.2d 354 (1976). Other perceived advantages to arbitration were confidentiality and the absence of a jury.

[102] Mastrobuono v. Shearson Lehman Hutton, Inc., 514 U.S. 52 (1995).

[103] In 2009 dispute resolution fees totaled $56.7 million out of total operating revenues of $708 million, or 7.27%. In 2008 they accounted for $42.3 million out of total operating revenues of $779 million, or 5.43%. 2009 FINRA ANN. FIN. REP. 3. Member firms pay higher fees than customers. *See* FINRA, Rules of Arbitration Procedure 12900-12901.

Moreover, we can expect the industry will mount opposition to Rule 12200 and assert that it is unfair to give investors the choice of litigation or arbitration while not giving the same choice to the industry. SIFMA has previously stated that eliminating PDAAs would give investors "an unfair strategic advantage." [104] FINRA, in contrast, has stated that Rule 12200 is an integral part of investor protection if mandatory securities arbitration is abolished.[105] Accordingly, we can expect that if mandatory securities arbitration is abolished, Rule 12200 will be the next battle.

How compelling is FINRA's argument that Rule 12200 is necessary for investor protection? Recall that under classical economic theory, regulatory authority should not interfere with the parties' bargaining over PDAAs.[106] Behavioral economics theory provides support for regulating the fairness of PDAAs and supports some degree of paternalism to protect individuals from their cognitive infirmities. Behavioral economics does not, however, fully support maintaining Rule 12200 to give investors the choice between arbitration and litigation. FINRA's argument in support of Rule 12200 is that the consequence of not allowing investors and firms to agree, predispute, to arbitrate their claims is that, post-dispute, some investors will, as a practical matter, be foreclosed from maintaining their claims. Accordingly, Rule 12200 is necessary for protection of at least investors with small damages claims. In addition, since investor confidence is essential to maintaining strong capital markets,[107] the anger that could result if small investors had no realistic remedy for losses caused by broker misconduct could negatively impact the markets. Accordingly, a strong argument can be made for the continued existence of Rule 12200 based on market realities and the policy judgment that retail investor confidence is important for maintaining the capital markets. An industry challenge to Rule 12200 would test the extent of FINRA's power and commitment to protect investors and maintain investor confidence in the capital markets. If SIFMA decides to mount an attack on Rule 12200, ultimately the SEC may have to assess the importance of providing retail investors, particularly those with small claims, a feasible remedy for broker misconduct. If PDAAs in securities arbitration are prohibited, the results may be disadvantageous to small investors.

V. CONCLUSION

This paper addressed four questions about FINRA securities arbitration and explored whether behavioral economics can help answer them. It found that behavioral economics principles provide support for regulating PDAAs in securities arbitration. Limits on investors' cognitive abilities, however, do not support FINRA Rule 12200. Rather, Rule

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[104] *See* SIFMA WHITE PAPER, *supra* note 19, at 3 (eliminating PDAAs would give investors "an unfair strategic advantage").

[105] *See* Linda Fienberg, President, FINRA Dispute Resolution, SEC Investor Advisory Committee: Open Meeting (May 17, 2010), http://www.sec.gov/news/otherwebcasts/2010/ iacmeeting051710.shtml.

[106] *See supra* note 42 and accompanying text. Professor Stephen Ware has specifically criticized FINRA Rule 12200 for this reason. Stephen J. Ware, *What Makes Securities Different From Other Consumer and Employer Arbitrations?*, 76 U. CIN. L. REV. 447, 452 (2008).

[107] SRO Rules must be consistent with the requirements of 15 U.S.C. § 15A(b)(6), which states that rules must be designed, in general, to "protect investors and the public interest." 15 U.S.C. § 19(b)(2). FINRA describes its "chief role . . . to protect investors by maintaining the fairness of the U.S. capital markets." FINRA Homepage, http://www.finra.org/.

12200's justification must be based on the need to maintain retail investors' confidence in the capital markets.