U.S. Securities and Exchange Commission

Office of the Investor Advocate

June 2023

Mandatory Arbitration among SEC-Registered Investment Advisers

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OVERVIEW

In January 2023, the Securities and Exchange Commission ("SEC") Office of the Ombuds, in collaboration with staff from the Office of the Investor Advocate, (together collectively, "Staff") conducted a study to evaluate: (1) the occurrence of mandatory arbitration clauses in SEC-registered investment adviser agreements; (2) the occurrence of certain restrictive terms in mandatory arbitration clauses, such as damage limitations and class action waivers; (3) the frequency of SEC-registered adviser arbitration; (4) the frequency of unpaid arbitration awards among SEC-registered advisers; and (5) the effects of mandatory arbitration clauses on clients harmed by their advisers.

Staff reviewed a sample of investment advisory agreements and compiled data regarding the occurrence of mandatory arbitration clauses, as well as the occurrence of various restrictive terms. To correct any potential non-representativeness of this sample, Staff used inverse probability weighting to generate this data.

Due to the lack of publicly available information about SEC-registered adviser arbitration, Staff could neither determine the frequency of adviser arbitration nor the frequency of unpaid adviser awards. Staff also could not identify a representative sample of advisory clients to determine the effects of mandatory arbitration clauses. Instead, as a proxy for the perspectives of advisory clients, Staff interviewed eight external stakeholder groups identified as having information relevant to the issue of mandatory arbitration, and/or as having publicly expressed opinion on the issue of mandatory arbitration. Their views, while anecdotal, provided insight into the potential harms and benefits of mandatory arbitration clauses for advisory clients.

ACKNOWLEDGEMENTS

We wish to thank the American Association of Individual Investors (AAII); Better Markets, Inc.; Financial Industry Regulatory Authority Dispute Resolution Services (FINRA DRS); Financial Services Institute, Inc. (FSI); Investment Adviser Association (IAA); North American Securities Administrators Association (NASAA); Public Investors Advocate Bar Association (PIABA); Securities Industry and Financial Markets Association (SIFMA), the American Arbitration Association (AAA); and JAMS ADR for contributing information and views on the issues addressed in this study. The SEC Division of Investment Management, Division of Trading and Markets, Division of Examinations, Division of Economic and Risk Analysis, and the Office of the General Counsel also contributed to the contents of this study.

DISCLAIMER: The Commission has expressed no view regarding the data, analyses, findings, and conclusions contained in this report. The report does not necessarily reflect the views of the Commission, the Commissioners, or staff of the Commission. This report is being published by the Office of the Investor Advocate, which is tasked with studying a broad range of issues relevant to the Commission's mission. Its publication is intended to stimulate discussion and critical comment and does not indicate a Commission determination to take any particular action.

SUMMARY OF FINDINGS

- ### Occurrence of Mandatory Arbitration Clauses and Other Arbitration Terms

Based on the sample of 579 advisory agreements reviewed, Staff estimated that approximately 61 percent[1] of SEC-registered advisers serving retail investor clients incorporated mandatory arbitration clauses into their investment advisory agreements.

Of the agreements that contained mandatory arbitration clauses, Staff estimated the frequency with which advisers[2] incorporated the specific terms below as follows:

TABLE: FREQUENCY OF SPECIFIC PROVISIONS IN MANDATORY ARBITRATION CLAUSES

Agreement designates a specific dispute resolution forum:	92%
When designating a forum, advisers designated the following fora:	
American Arbitration Association ("AAA")	83%
Financial Industry Regulatory Authority (FINRA) Dispute Resolution Services ("FINRA DRS")	10%
JAMS	6%
Other	1%
Agreement designates specific forum rules:	37%
When designating forum rules, advisers selected the following rules:	
AAA Commercial Rules	83%
JAMS Streamlined Rules and Procedures	3%
JAMS Comprehensive Rules and Procedures	2%
AAA Securities Arbitration Supplementary Procedures	1%
Agreement designates the arbitration venue:	60%
When designating arbitration venue, percent of agreements that did not consider client's location or place of business:	97%
Agreement precludes participation in class action	6%
Agreement limits claims the client may assert	5%
Agreement limits damages that may be awarded	11%
Agreement includes fee-shifting provision	18%

- ### Frequency of Adviser Arbitration, Unpaid Awards

State-registered advisers, investment adviser representatives, and SEC-registered advisers are not uniformly required to disclose information about arbitrations with their clients.[3] Moreover, SEC-registered advisers' preferred dispute resolution fora do not track the number of adviser arbitrations. For these reasons, Staff could not obtain data about the frequency of arbitration or unpaid awards among SEC-registered advisers.

As a related point, private arbitrators lack jurisdiction over the parties after an award is issued. Parties to an arbitration are expected to abide by the terms of the arbitrator's award.[4] However, when a party fails to comply with an arbitration award, the other party may need to enforce the award through the court system and litigate a dispute over an unpaid award. A survey of federal and state case law did not yield results upon which to reliably estimate the frequency of litigation involving unpaid arbitration awards among advisers.

- **Stakeholder Perspectives**[5]

Stakeholders unanimously agreed that mandatory arbitration clauses benefited *advisers* by, among other things, simplifying the dispute resolution process through limited discovery[6] eliminating the right to appeal,[7] maximizing privacy during and after the arbitration, and increasing both predictability and efficiency through the designation of a known arbitration forum with familiar rules. Proponents of mandatory arbitration further asserted that advisory clients – like their advisers – experienced these same benefits.

In contrast, critics of mandatory arbitration argued that advisers experienced these benefits at the expense of clients. Because advisers unilaterally draft their advisory agreements, critics believed advisers often selected the forum, the rules, and the venue that would likely increase costs for the client and favor the adviser. They also asserted that the limited ability to exchange information during discovery might prevent clients from obtaining evidence to prove their claims, and the inability to appeal would likely preclude review of an arbitrator's decision. Critics also asserted the lack of uniform disclosure requirements for adviser arbitration information might allow recidivist advisers to conceal client allegations of wrongdoing from regulators and prospective clients.

Stakeholders agreed, to varying degrees, that advisers should consistently be required to disclose more complete information about customer arbitrations and unpaid awards. Proponents of mandatory arbitration argued that, while disclosure of all customer allegations might subject advisers to unwarranted reputational harm, full and fair disclosure of allegations the adviser deems material would create a competitive advantage for honest advisers and promote fairer markets. Critics of mandatory arbitration more broadly argued that advisers' fiduciary duty necessitated disclosure of customer arbitration information, irrespective of whether the adviser deemed the information material.

Several stakeholders also stated that differences between the adviser and broker[8] arbitration regimes disadvantaged advisory clients. For instance, some stated that certain provisions permissible in advisory agreements, such as class action waivers, damage limitations and claim limitations, are impermissible in agreements between brokers and their customers. These stakeholders further argued that such limiting terms negatively affect arbitral outcomes for advisory clients. Others stated that the costs associated with private adviser arbitration significantly exceed the costs associated with broker arbitration, and, in some instances, the high costs could preclude advisory clients from filing arbitration claims at all.

- **Comparison with Broker Arbitration**

A comparison of relevant rules in the FINRA Code of Arbitration Procedure for Customer Disputes ("FINRA Code") supported stakeholder concerns about the use of restrictive terms in advisory agreement mandatory arbitration clauses. While the FINRA Code applies uniformly to disputes between customers and their brokers and governs contractual provisions relating to mandatory arbitration,[9] advisers may choose the terms of their respective mandatory arbitration clauses.

As noted above, 6 percent of SEC-registered advisory agreements with mandatory arbitration clauses included class action waivers, 5 percent of agreements limited the types of claims that could be asserted, and 11 percent limited the types of damages that a client may seek in the arbitration. In contrast, the FINRA Code prohibits usage of class action waivers,[10] prohibits language that limits a party's ability to file "any claim" in arbitration,[11] and prohibits language that limits the ability of arbitrators to make "any award."[12]

Of the 60 percent of mandatory arbitration clauses that designated a venue for the arbitration hearing, 97 percent designated a location that disregarded the client's location. In practice, clients could be required to participate in an arbitration far from their place of residence, incurring travel and lodging expenses to attend in-person hearings. Under the FINRA Code, the default location for the arbitration venue is generally the hearing location nearest the customer's residence at the time of the events leading to the dispute.[13]

A notable percentage of advisory agreements with mandatory arbitration clauses also imposed requirements on the type and/or number of arbitrators – *e.g.,* requiring a panel of three arbitrators, or requiring arbitrators affiliated with the securities industry. Because each arbitrator is compensated separately, a panel of three arbitrators would predictably increase the cost associated with the arbitration. Several stakeholders also suggested that arbitrators with securities industry ties might be biased in favor of advisers. By comparison, the FINRA rules require panels to consist of a single arbitrator, unless the claim amount exceeds $100,000, or the parties jointly agree to a three-arbitrator panel.[14] In cases with one arbitrator, the FINRA Code requires the selection of a public arbitrator, unaffiliated with the securities industry, to preside over the dispute.[15] In cases with three arbitrators, the FINRA Code guarantees parties the ability to select a panel of all public arbitrators.[16]

Although arbitrators in FINRA DRS are not required to write opinions or provide explanations for an award, arbitrator awards must be in writing.[17] In contrast, many advisory agreements included provisions that prohibited arbitrators from providing written awards.

Staff's review also supported the notion that costs of adviser arbitration generally exceed those of broker arbitration. For instance, the frequent designation of commercial, or business-to-business, arbitration rules result in higher initial filing fees and other expenses for clients, potentially making the filing of a claim cost-prohibitive. Conversely, as noted above, the FINRA Code of Arbitration Procedure for *Customer* Disputes governs all disputes between brokers and their customers. In FINRA DRS, initial filings fees range from $50 (for matters valued up to $1,000) to a maximum of $2,300 (for matters valued over $5,000,000).[18] Under the AAA Commercial Arbitration Rules, clients bringing a matter valued at $75,000 or less must pay an initial filing fee of $925 if the panel consists of one arbitrator.[19] AAA commercial arbitrations with three or more arbitrators are subject to a minimum initial filing fee of $4,400.[20]

CONCLUSIONS

Based on Staff estimates, most investment advisory agreements contain mandatory arbitration clauses, and some contain restrictive terms that could negatively affect the arbitration process or outcome for clients. The Table above reflects the approximate frequency with which such terms are included in advisory agreements. As stated by stakeholders, some of these restrictive terms are impermissible in agreements between brokers and their customers (such as terms prohibiting class actions or specifying certain forum locations). Stakeholder views regarding the potentially negative impact of these terms on advisory clients merits further exploration.

Given the absence of publicly available information about adviser arbitration or the number of unpaid awards, a quantitative evaluation of the "effects" of mandatory arbitration clauses would also require further inquiry. Establishing uniform disclosure requirements for adviser arbitration information could, as some stakeholders suggested, increase public access to this information, as well as regulatory and investor insight into the conduct of SEC-registered advisers.

[1] The margin of error for a 95% confidence interval on these estimates varies but is no greater than +/- 6 percentage points.

[2] Unless otherwise noted, the term "investment adviser" or "adviser" generally refers to investment advisers that provide financial services to retail customers and are registered with the SEC.

[3] State-registered advisers and investment adviser representatives are required to disclose certain information about arbitrations with clients. *See* Uniform Application for Investment Adviser Registration, Form ADV Part 1B, Item 2.E (applicable to state-registered advisers); Uniform Application for Securities Industry Regulation or Transfer, Form U4, Item 14.I (applicable to individual adviser representatives). By comparison, SEC-registered advisers are not specifically required to disclose information about arbitrations with clients, but they must disclose "all material facts relating to the advisory relationship." *See* Uniform Application for Investment Adviser Registration, Form ADV Part 2, Uniform Requirements for the Investment Adviser Brochure and Brochure Supplements, General Instruction 3.

[4] *See* AAA, "What Happens after the Arbitrator Issues an Award," at 1 ("Many parties will voluntarily follow the arbitrator's decision; however, the AAA and the arbitrator do not have the authority to actually make a party do what the award says."), https://www.adr.org/sites/default/files/document_repository/AAA229_After_Award_Issued.pdf (last visited September 15, 2023).

[5] The stakeholders interviewed for purposes of this study include American Association of Individual Investors; Better Markets, Inc.; Financial Industry Regulatory Authority Dispute Resolution Services; Financial Services Institute, Inc.; Investment Adviser Association; North American Securities Administrators Association; Public Investors Advocate Bar Association; and Securities Industry and Financial Markets Association.

[6] *See, e.g*., FINRA, The Neutral Corner, Vol. 2-2011 (2011), at 1, https://www.finra.org/sites/default/files/Publication/p123535.pdf ("Discovery in FINRA arbitration is more limited than discovery under the Federal Rules of Civil Procedure or state discovery rules.")

[7] *See supra* note 4, "What Happens after the Arbitrator Issues an Award," at 2, ("There is no right to appeal in arbitration like there is in court").

[8] The term "broker" as used in this report refers to broker-dealers required to register with the SEC and with FINRA, along with their associated persons, as the term "associated person" is defined under FINRA Rule 1011(b).

[9] FINRA Rule 12101.

[10] FINRA Rule 12204(a).

[11] FINRA Rule 2268(d)(2).

[12] FINRA Rule 2268(d)(4).

[13] FINRA Rule 12213.

[14] FINRA Rule 12401. To note, claims of $50,000 or less must be adjudicated by one arbitrator.

[15] FINRA Rule 12402(a). For the definition of a "public arbitrator," *see* FINRA Rule 12100(aa).

[16] FINRA Rule 12403.

[17] *See* FINRA, Decision and Award, https://www.finra.org/arbitration-mediation/decision-award#:~:text=Arbitration%20Award,date%20the%20record%20is%20closed.

[18] FINRA Rule 12900.

[19] AAA, Commercial Arbitration Rules and Mediation Procedures, Administrative Fee Schedules, at 1 (Amended and Effective May 1, 2018), https://www.adr.org/sites/default/files/Commercial_Arbitration_Fee_Schedule_1.pdf (last visited September 15, 2023).

[20] *Id.* at 2.