Beyond the Brokerage Fee: The Hidden Cost of Investment Through Brokerage Firms—Due Process Protection

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I. INTRODUCTION

Millions of Americans rely on individual brokers or brokerage firms to invest their money hoping to better support their families and eventually retire. For the many Americans unfamiliar with investment strategies, a broker may be the only means of accomplishing these goals. While most investors are willing to pay a reasonable brokerage fee to increase the likelihood of a return, investors entering into brokerage contracts must also sacrifice a substantial possession beyond the fee: their basic due process rights should the deal sour.

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The reason for this, at its simplest, is that investors entering into brokerage contracts are forced to sign pre-dispute arbitration clauses. The Financial Industry Regulatory Authority (FINRA) is responsible for all dispute resolutions involving brokers, and as a private entity, FINRA is not required to abide by governmental due process guarantees. Thus, the individual investor signing a brokerage contract is simultaneously signing away his due process protections.

This Note examines the development and effectiveness of FINRA's regulatory regime, as well as the due process rights it curtails. In doing so, it not only outlines the potential due process deprivations of FINRA's dispute resolution mechanisms, but also explores how these deprivations have already occurred in practice. After concluding that these deprivations cannot be justified for a myriad of reasons, this Note offers two recommendations to protect investors' due process rights and create a more effective broker-investor dispute resolution process.

II. BACKGROUND

Before determining the extent to which pre-dispute arbitration clauses in brokerage contracts affect a claimant's due process rights, it is first necessary to outline the regulatory framework governing securities disputes.[1] First, this Part describes the development,[2] functional authority,[3] and arbitration processes[4] of FINRA. Then, this Part proceeds to explain the development and use of pre-dispute arbitration clauses in the brokerage industry.[5]

A. The Development of FINRA

Today, FINRA is the largest private securities regulator in the United States.[6] FINRA writes and enforces regulations that every brokerage firm, and every broker, must abide by—4400 securities firms and 630,000 brokers in total.[7] Although FINRA is a non-profit, self-regulatory organization (SRO), its assets total over $2.2 billion,[8] and in 2014 alone it levied $166.3 million in fines.[9] Today, then, the nation's predominant securities regulator[10] is a private SRO worth billions of dollars;[11] it took decades of legal developments, however, to arrive at this regulatory format.

For over 200 years, securities exchanges in the United States have enjoyed self-

1. *See infra* Part II.B (describing FINRA's authority and its lack of judicial and executive oversight of its procedures and determinations).

2. *See infra* Part II.A (discussing FINRA's development).

3. *See infra* Part I.B (describing FINRA's authority).

4. *See infra* Part II.C (outlining FINRA's dispute resolution processes).

5. *See infra* Part II.D (explaining why mandatory pre-dispute arbitration clauses are binding in the securities context).

6. *About FINRA: Leadership*, FINRA, http://www.finra.org/AboutFINRA/Leadership/ (last visited Jan 17, 2015).

7. *Get To Know Us*, FINRA (2012), *available at* http://www.finra.org/web/groups/corporate/@corp/@about/documents/corporate/p118667.pdf.

8. Kenneth B. Orenbach, *A New Twist to an On-Going Debate About Securities Self-Regulation: It's Time to End FINRA's Federal Income Tax Exemption*, 31 VA. TAX REV. 135, 159 (2011).

9. *About FINRA*, FINRA, http://www.finra.org/AboutFINRA/ (last visited Feb. 22, 2015).

10. *Get To Know Us*, *supra* note 7, at 2.

11. Orenbach, *supra* note 8, at 159.

governance over all members listing securities on their exchange.[12] While keeping the self-regulatory platform, however, the Securities Exchange Act of 1934 (the Exchange Act), required every securities exchange in the United States to register with the newly created SEC.[13] The Exchange Act gave the SEC oversight of the activities of stock exchanges, such as the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE);[14] however, enforcement mechanisms for securities violations and violations of membership rules remained within the SRO itself.[15] In 1938, the government expanded its regulatory reach to over-the-counter securities markets, thereby giving the Securities Exchange Commission (SEC) oversight of both exchanges and non-exchanges.[16] At this time, the NASD registered with the SEC regulatory authority and retained control over its members, and eventually the National Association of Securities Dealers Automated Quotations (NASDAQ).[17] Concurrently, the NYSE continued to monitor its members internally through an enforcement division.[18] This changed in 2007 when "FINRA assumed the NASD's enforcement and regulatory functions and the NYSE and NASD dispute resolution programs were consolidated under FINRA's authority."[19] This consolidation of SROs into FINRA, itself under the supervision of the SEC as a non-exchange SRO, reflects the current securities regulatory format.

B. FINRA's Authority

FINRA possesses the same authority that its predecessor, NASD, did: the ability to enforce federal securities violations and membership rules,[20] as well as the ability to manage its members' trades.[21] Of equal importance is that FINRA obtained exclusive authority to regulate the actions of, and disputes involving, brokers.[22] In FINRA's words, it "write[s] and enforces rules and regulations for every single brokerage firm and broker in the United States."[23] Further, because courts have continually held SROs are entitled to

12. *See* Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. 151, 159 (2008) (explaining that the original motivation behind creating securities SROs was that the United States government participated in a bond market scandal in 1792).

13. *See* Jennifer M. Pacella, *If the Shoe of the SEC Doesn't Fit: Self-Regulatory Organizations and Absolute Immunity*, 58 WAYNE L. REV. 201, 206 (2012) (describing the government's desire to create some form of oversight authority to monitor SRO rules and enforcement as the motivation behind creating the SEC).

14. *Id.* at 207.

15. *See* 15 U.S.C. § 78b (2010) (explaining that securities exchanges regulate themselves with SEC oversight).

16. *See* Pacella, *supra* note 13, at 206–07 ("The original Exchange Act did not extend federal regulation to non-exchange or over-the-counter (OTC) markets. The Maloney Act was enacted in 1938 to require national securities associations engaged in OTC market trading to be registered with the SEC . . . . The Maloney Act obligated national securities associations to follow [the same] rules . . . as exchanges were required to do for listed markets.") (internal citations omitted).

17. *See id.* at 207 (explaining that NASDAQ is a NASD spin off that raised NASD $1.5 billion in equity).

18. David B. Lipsky et al., *The Arbitration of Employment Disputes in the Securities Industry: A Study of FINRA Awards, 1986-2008*, DISPUTE RESOLUTION J. 12 (CORNELL UNIVERSITY ILR SCHOOL Feb./Apr. 2010), *available at* http://digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1785&context=articles.

19. *Id.* at 54.

20. *See* Pacella, *supra* note 13, at 207 (describing the regulatory powers of securities SROs).

21. *Id.*

22. *See supra* Part III.A (describing FINRA's monopolistic governance of brokers).

23. *Get to Know Us*, *supra* note 7, at 2.

absolute immunity for their quasi-governmental duties,[24] FINRA is free to exercise its regulatory duties, including arbitrating broker disputes, without fear of repercussion.[25] The Second Circuit has recently expanded SROs' absolute immunity protections by declaring that they cannot be sued for any action incidental to their quasi-public duties.[26] While the SEC continues to have oversight over FINRA's actions,[27] it has historically declined to exercise that power, especially in arbitration disputes.[28] Given the expansive reach of those subject to FINRA regulations, FINRA's freedom to govern as it sees fit, and the finality of its decisions, FINRA possesses extremely broad authority in controlling the massive securities market and its actors.

C. FINRA's Arbitration Process and Judicial Involvement

Although FINRA's arbitration process for investors is governed by the procedures in its Customer Code,[29] it is also considered a private organization by courts in the context of constitutional protections.[30] Thus, FINRA has a great deal of discretion to amend, disregard, or interpret its Customer Code provisions.[31] The SEC and judiciary further this discretion by applying a highly deferential review of FINRA awards.[32] With this regulatory framework as a backdrop, this section outlines the specifics of FINRA's arbitration processes[33]—both in theory and fact—and continues on to explain the exact standards courts use in reviewing FINRA awards and processes.[34]

1. FINRA's Arbitration Process

When a dispute arises involving a broker or brokerage firm, FINRA's arbitration process is the sole resolution mechanism.[35] FINRA governs broker-investor disputes

24. *See* Pacella, *supra* note 13, at 211–13 (describing that while courts have always been given absolute immunity in adjudication, courts have expanded that concept—initially, this protection was only offered to government officials who performed adjudicatory functions, but has further been expanded to SROs).

25. *See* Standard Inv. Chartered Inc. v. Nat'l Ass'n of Sec. Dealers, Inc., 637 F.3d 112, 115 (2d Cir. 2011) (holding that private suits cannot be filed against an SRO for executing its quasi-governmental responsibilities); *see also In re* NYSE Specialists Sec. Litig. v. N.Y. Stock Exch., Inc., 503 F.3d 89, 97 (2d Cir. 2007) (holding that the same protections apply for an SRO's failure to execute its duties).

26. Ilya Shapiro, *Financial Regulators Are Not Above the Constitution*, CATO INSTITUTE (Oct. 26, 2011, 11:55 AM), http://www.cato.org/blog/financial-regulators-are-not-above-constitution.

27. Pacella, *supra* note 13, at 206–07.

28. Benjamin J. Warach, *Mandatory Securities Arbitration After FINRA Rule 12403(D): The Debate Remains the Same*, 18 PIABA B. J. 109, 120 (2011).

29. *Id.* at 126.

30. *See* Karmel, *supra* note 12, at 171 ("[C]ourts have refused to grant persons under investigation the right to claim the Fifth Amendment on the grounds that SROs are private bodies.").

31. Warach, *supra* note 28, at 129−30, 137.

32. *See infra* Part II.C.2 (describing the courts' reluctance to overturn any FINRA ruling on procedural grounds or on the merits).

33. *Infra* Part II.C.1.

34. *Infra* Part II.C.2.

35. *See infra* Part II.D (explaining that all investor–broker disputes are resolved through FINRA's arbitration proceedings due to the pre-dispute arbitration agreements brokerages require investors to sign); *see also* McMahon v. Shearson/Am. Express, Inc., 788 F.2d 94, 96–98 (2d Cir. 1989) (holding that mandatory pre-dispute arbitration contracts were valid in the consumer-broker context when supported by state arbitration legislation).

"pursuant"[36] to its Customer Code, which contains no formal due process protocol.[37]

> These Customer Code provisions include language requirements for the content and form of brokerage firms' predispute arbitration clauses, fair notice of pleadings, an opportunity to be heard (applicable only to cases involving an amount in dispute of greater than $25,000), a right to represent oneself or be represented by an attorney or other third party, a hearing location that is convenient for the customer, and a customer's ability to prevent individuals with industry affiliations from serving on the arbitration panel.[38]

Additionally, FINRA's recent enactment of Rule 12403(d) provides litigants in disputes involving over $100,000 a three-arbitrator panel.[39] Despite the Customer Code's robust regulatory framework for arbitration proceedings, several aspects of the process leave investor-litigants with substantially fewer procedural safeguards than would a judicial remedy.[40]

The FINRA Customer Code omits three due process protections that are considered fundamental in traditional adjudication.[41] First, FINRA lacks a requirement for written opinions in arbitration proceedings.[42] Second, the Customer Code's lack of requirements assuring investor-litigants' right to be heard in cases involving less than $25,000.[43] Finally, customers are denied a neutral arbitrator because FINRA arbitrators often have potential conflicts of interest because they are members of the financial industry or SEC officials.[44]

Unlike judicial resolutions, parties must go through several procedural requirements to obtain a written explanation of a FINRA arbitration award.[45] Both parties must request a written decision from the arbitration panel 20 days before the hearing date.[46] Additionally, FINRA charges $400 for a written decision, an expense that the panel can award to either party at its discretion.[47] While an arbitrator may issue a written opinion

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36. I place quotes around pursuant because, as an SRO with little oversight from the SEC, FINRA arbitrators have a great deal of freedom to interpret what the Customer Code actually requires. *See supra* Part II.B (describing FINRA's absolute immunity and the resulting freedom to regulate).

37. Warach, *supra* note 28, at 126.

38. *Id.* at 126–27 (citing FINRA Rule 3110(f); FINRA Rule 12300; FINRA Rule 12600; FINRA Rule 12208(a)−(c); FINRA Rule 12213(a); FINRA Rule 12403(d)).

39. Warach, *supra* note 28, at 129.

40. *See infra* Part II.C.1 (describing the procedural safeguards the FINRA arbitration process does not include).

41. *See* Warach, *supra* note 28, at 122 (outlining FINRA's Customer Code requirements, which do not include the right to written opinion or hearing); *see also infra* Part II.C.1 (describing the inherent conflicts of interest of FINRA arbitrators).

42. *See* FINRA Rule 12514(d) ("At least 20 days before the first scheduled hearing date, all parties must submit to the panel any joint request for an explained decision . . . .").

43. Warach, *supra* note 28, at 126–27.

44. *See id.* at 134, 136 (explaining that claimants have a right to an arbitration panel consisting of solely public arbitrators, but arbitrators considered "public" still may receive up to 10% of their income from financial industry services); *see also* D'Alessio Sec., Inc., v. SEC, 380 F.3d 112, 122 (2004) (deciding that an SEC official's potential desire to please his superiors by ruling against a plaintiff in a FINRA arbitration hearing did not compromise that official's impartiality).

45. FINRA Rule 12514(d); FINRA Rule 12904(g).

46. FINRA Rule 12514(d).

47. *See* FINRA Rule 12904(g)(5) ("The chairperson will receive an additional honorarium of $400 for writing the explained decision . . . . The panel will allocate the cost of the chairperson's honorarium to the parties[.]").

absent these requirements, they are unlikely to do so because, absent a joint request for a written decision, they are not compensated for issuing one.[48] Given these disincentives, arbitrators often resolve disputes without providing claimants a cornerstone of the American legal process—a written opinion.

The second significant procedural safeguard that the FINRA arbitration process does not guarantee is the right to be heard in claims involving less than $25,000; in fact, the FINRA Customer Code expressly denies that right.[49] Further, "courts find that arbitrators have the authority to decide pre-hearing motions to dismiss."[50] This authority allows arbitrators to dismiss a claim because it failed to meet the pleading requirements required by the Federal Rules of Civil Procedure.[51] Courts will intervene and require an arbitration hearing only if the arbitrator's decision to deny a hearing is "fundamentally unfair."[52] Thus, FINRA arbitration proceedings are free to adopt aspects of traditional judicial procedures that curtail the right to be heard, such as dismissing claims at the pre-hearing stage, but are not required to adopt those judicial procedures that promote the right to be heard.[53]

FINRA arbitration processes also fail to assure the impartiality of the decision maker.[54] In the years prior to the enactment of Customer Code Rule 12403(d), FINRA received numerous complaints that its arbitrators were non-public; either FINRA or SEC officials themselves or other actors in the securities industry were serving as FINRA arbitrators.[55] Although there are several reasons why an intra-industry arbitrator's impartiality may be questionable,[56] FINRA's attempts to ensure impartiality have been minimal,[57] and the courts have been reluctant to intervene.[58] While it is likely that many FINRA arbitrators are indeed impartial, the concern remains self-evident, especially for investors with claims for less than $100,000 who do not get protection from FINRA Rule 12403(d), which ensures a three arbitrator panel including at least one public arbitrator.[59]

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48. Warach, *supra* note 28, at 122–23.

49. *See* FINRA Rule 12600 ("A 'simple arbitration' process, involving no hearing, is applied to cases involving amounts in dispute of $25,000 or less."); *see also* FINRA Rule 12800(a) (describing the "simple arbitration" process, which does not include a right to be heard).

50. Jill I. Gross, *McMahon Turns Twenty: The Regulation of Fairness in Securities Arbitration*, 76 U. CIN. L. REV. 493, 507 (2008).

51. *Id.* at 508.

52. *Id.* at 507.

53. *See id.* at 508 ("These alarming decisions treat securities arbitration as a litigation-like process, but they deprive disputants of an evidentiary hearing on grounds that simply do not apply to arbitration.").

54. *See* Warach, *supra* note 28, at 130 ("Empirical research may confirm industry affiliates' tendency to side with brokers or brokerage firms in securities disputes.").

55. *Id.*

56. *See* Stephen J. Choi et. al., *Attorneys As Arbitrators*, 39 J.L. STUD. 109, 129 (2010) (explaining that arbitrators who act as attorneys for brokerage firms or brokers may side with them over investors in disputes, that they may have an excessively sympathetic view of the industry generally, or they may be particularly skeptical of investor claims because of past experiences).

57. While FINRA Rule 12403(d) allows either party to demand that all arbitrators are "public," it was only enacted in 2011 and only applies to claims of over $100,000 involving three person arbitration panels. FINRA Rule 12403(d). Further, "public" panel members may still be involved in the securities industry. *See* Warach, *supra* note 28, at 134 (noting the existence of panel members who are still involved in the securities industry).

58. *See* Georgios Zekos, *Realities of Securities Arbitration in the USA Today*, 12 VINDOBONNA J. INT'L COM. L. AND ARB. 33, 43–44 (2008) ("It follows that, with the prevailing absence of written reasons, judicial *vacatur* under the 'manifest disregard' standard is not common in securities matters.").

59. FINRA Rule 12403(d).

Given the lack of transparency in FINRA arbitration proceedings[60] and the extreme deference courts give to FINRA and SEC awards,[61] the effects of having an intra-industry arbitrator on investors are amplified.

2. Judicial Review of FINRA Awards and Procedures

Although "judicial review of arbitration awards is extremely narrow," both FINRA's procedures and awards can be appealed to the courts.[62] For appeals claiming procedural deficiencies in arbitration proceedings, courts invoke the "fundamental fairness" test,[63] giving a great deal of deference to the arbitrators[64] and "presum[ing] that [they] properly discharged their official duties."[65] In reviewing SEC[66] awards on the merits, the courts use equally stringent standards.[67] In reviewing the merits of SEC awards, courts use the "manifest disregard of the Law" standard.[68] For a party to prevail under this standard, it must prove that: "1) [t]he arbitrators knew of a governing legal principle yet refused to apply it or ignored it altogether; and 2) the law that the arbitrators ignored was well defined, explicit, and clearly applicable to the case."[69]

Courts also grant the SEC tremendous discretion in its factual findings: "the SEC's factual findings are conclusive, if they are supported by . . . 'a minimum quantity of relevant evidence objectively adequate to support the findings when viewed in light of the record as a whole.'"[70] These deferential standards of review, along with the SEC's hands-off oversight of broker-investor disputes,[71] mean that judicial remedies for alleged deficiencies in FINRA arbitration proceedings are essentially available to claimants only in theory.

D. Connecting Individual Investors to FINRA Arbitration Through Pre-Dispute Arbitration Clauses

Two distinct phenomena explain why an SRO originally created to regulate the securities market now serves as the sole dispute resolution mechanism for claimants in broker-investor disputes. One reason for FINRA's influence is the increased validity of arbitration awards generally.[72] Second, the Second Circuit's holding in *McMahon v. Shearson/American Express* declared that mandatory pre-dispute arbitration contracts are

60. Zekos, *supra* note 58, at 42–44.

61. *Infra* Part II.C.2.

62. Gross, *supra* note 50, at 503.

63. *Id.* at 499.

64. D'Alessio Sec. Inc., v. SEC, 380 F.3d 112, 123 (2004).

65. United States v. Armstrong, 517 U.S. 456, 464 (1996).

66. SEC and FINRA are used interchangeably in the context of judicial review or arbitration awards—FINRA awards are confirmed by the SEC before being appealed to the courts, so the cases all refer to the SEC. *See* Busacca v. S.E.C., 449 F. Appx. 886, 888 (11th Cir. 2011) (explaining that the court is reviewing the final order of an SEC decision that confirmed the initial ruling of FINRA).

67. GMS Group, LLC v. Benderson, 326 F.3d 75, 76 (2d Cir. 2003).

68. *Id.* at 77−78.

69. *Id.* at 78.

70. Rooms v. SEC, 444 F.3d 1208, 1212 (10th Cir. 2006) (quoting Lehl v. SEC, 90 F.3d 1483, 1485 (10th Cir. 1996)).

71. Warach, *supra* note 28, at 120.

72. *See* Gross, *supra* note 50, at 495 ("[T]he Supreme Court's . . . decisions in the past twenty years have imbued [arbitrators] with super status.").

enforceable in broker-investor disputes.[73]

In holding pre-dispute arbitration clauses valid in the securities context, the *McMahon* Court reasoned: "By agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than judicial, forum."[74] Yet courts did not always endorse this now predominant view; prior to the enactment of the Federal Arbitration Act of 1925 (FAA), courts were not even permitted to enforce arbitration agreements.[75] Fifty years ago, the Supreme Court expressly rejected the view expressed by the *McMahon* Court.[76] Not until 1985 did the Supreme Court switch course and hold that mandatory arbitration clauses did not compromise a claimant's statutory rights.[77] These cases illustrate the evolution of courts' views of arbitration from skepticism to endorsement, reflected in the deference courts currently give to arbitration awards[78] and proceedings.[79]

While it is now clear that the judiciary will enforce pre-dispute arbitration contracts in broker-investor disputes, the question remains why individual investors sign these contracts. The answer is simple: brokerage firms and individual brokers capitalized on the *McMahon* decision by uniformly inserting pre-dispute arbitration clauses in their investor contracts.[80] As such, "virtually all broker-dealers include a pre-dispute arbitration clause in their customer account agreements."[81] This means "arbitration is now considered mandatory for individual investors."[82] Thus completes the chain: all disputes involving brokers must be resolved through FINRA, and all investors wishing to invest through brokers must sign a pre-dispute arbitration contract. Therefore, all broker-investor disputes must be resolved through FINRA's arbitration procedures.

III. ANALYSIS: DUE PROCESS DEPRIVATIONS IN FACT

This Part focuses not only on the aforementioned three due process weaknesses in FINRA dispute resolution arbitration[83] but also on affirmative judicially created restrictions on claimants' due process protections under such proceedings.[84] It explains that due process protections are not only denied to investor-litigants in broker-investor

73. McMahon v. Shearson/Am. Express, Inc., 788 F.2d 94, 96–98 (2d Cir. 1986) ("We hold that arbitration of the pendant state claims is required even though bifurcated proceedings may result.").

74. Mitsubishi Motor Corp. v. Soler Chrysler-Plymouth, 473 U.S. 614, 628 (1985).

75. *See* Richard A. Bales & Sue Irion, *How Congress Can Make a More Equitable Federal Arbitration Act*, 113 PENN ST. L. REV. 1081, 1085 (2009) ("In 1925, Congress passed the FAA to permit judicial enforcement of arbitration agreements covering contract disputes between parties of roughly equal bargaining power.").

76. *Id.* at 1082. *See also* Wilko v. Swan, 346 U.S. 427, 438 (1953) (holding that a mandatory arbitration clause between a securities buyer and broker was not enforceable).

77. *Mitsubishi*, 473 U.S. at 628.

78. *Supra* Part II.C.2.

79. *Id.*

80. Gross, *supra* note 50, at 494 n.9 (citing *The Securities Arbitration System: Hearing Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 109th Cong. 13–14 (2005) (statement of Constantine Katsoris, Wilkinson Professor of Law, Fordham University Law School) (testifying that *McMahon* "virtually transformed" securities arbitration "from a voluntary procedure to a mandatory one")).

81. *Id.* at 494.

82. *Id.* at 514.

83. *Supra* Part II.C.1.

84. *See infra* Part III.A (describing that Fifth Amendment protections do not apply to FINRA disputants).

disputes but also to brokers in every type of dispute in which they are involved.[85] This Part then illustrates that investor-litigants are especially victimized in the current regulatory framework because pre-dispute arbitration clauses are adhesive, giving investor-litigants no choice as to whether they sacrifice their due process rights.[86] Finally, this Part examines the effectiveness of FINRA in carrying out its regulatory responsibilities to determine whether such deprivations are justified by particularly just results and concludes they are not.[87]

A. Judicially Created Due Process Deprivations

While courts' reluctance to mandate what due process requires in FINRA's dispute resolution process has allowed FINRA great flexibility in their dispute resolution procedures,[88] courts have been less hesitant to declare which constitutional rights disputants do not possess.[89] Courts have held that FINRA is a private entity—and therefore not required to abide by due process safeguards—in the context of investor–broker disputes[90] and FINRA-led broker disciplinary proceedings,[91] but FINRA receives the absolute immunity of a state actor in all civil claims against FINRA and its officials.[92] These developments have led to a worst-of-both-worlds situation for investor and broker disputants—they are affirmatively deprived of some substantive and procedural constitutional rights and left without redress for FINRA's deprivation of others.[93]

While investors' deprivation of due process rights is generally a result of judicial passivity[94]—as are many brokers' rights—brokers involved in FINRA investigations are affirmatively denied their constitutional rights as well—namely by courts' insistence that they are not entitled to Fifth Amendment protections.[95] These deprivations are especially egregious for several reasons: first, FINRA has the authority to fine, suspend, or expel

85. *See infra* note 104 and accompanying text (explaining that both brokers and investors are bound by pre-dispute arbitration contracts).

86. Gross, *supra* note 50, at 514 ("[A]rbitration is now considered mandatory for individual investors.").

87. *See* Steven Irwin et al., *Self-Regulation of the American Retail Securities Markets—An Oxymoron for What is Best for Investors?*, 14 U. PA. J. BUS. L. 1055, 1074 (2012) (providing that Bernie Madoff was the Vice-Chairman of FINRA and responsible for the enforcement of securities violations while he was orchestrating his Ponzi scheme).

88. *See supra* Part II.C.2 (describing how deferential oversight by reviewing courts afford FINRA great flexibility to interpret what due process requires).

89. Desiderio v. NASD, 191 F.3d 198, 206 (2d Cir. 1999).

90. *Id.* (denying that plaintiff's agreement to arbitration violated her constitutional rights; the court held NASD "is a private corporation . . . the fact that a business entity is subject to 'extensive and detailed' state regulation does not convert that organization's actions into those of the state").

91. *See* United States v. Solomon, 509 F.2d 863, 869 (2d Cir. 1975) (holding that NYSE was a private entity so plaintiff, under investigation for NYSE violations, was not entitled to Fifth Amendment protections).

92. Standard Inv. Chartered Inc. v. Nat'l Ass'n of Sec. Dealers, Inc., 637 F.3d 112, 115 (2d Cir. 2011); *In re* NYSE Specialists Sec. Litig. v. N.Y. Stock Exch., Inc., 503 F.3d 89, 97 (2d Cir. 2007).

93. *See Desiderio*, 191 F.3d at 206 (explaining that plaintiff's constitutional claims did not apply to NASD actions because it was a private actor).

94. Courts' general refusal to overturn FINRA awards based on due process violations allows the SRO to implement policies curtailing due process rights. *See infra* Part II.C.2 (describing the deferential standards of review used by courts when hearing FINRA claims on appeal). This is in contradistinction to courts' affirmative rulings that broker-disputants are not entitled to Fifth Amendment protection described in this section.

95. *Solomon*, 509 F.2d at 869.

brokers in violation of FINRA policy.[96] Thus, while investor dispute resolution is primarily civil, or compensatory, in nature, brokers' disputes are often criminal—punishment oriented—in nature, meaning adverse results can destroy careers and livelihoods.[97] Second, testimony that could not be compelled by the government in a criminal action can nonetheless be compelled through FINRA action and used in simultaneous government prosecutions.[98] Finally, because brokers receive no Fifth Amendment Double Jeopardy protection,[99] they may be subject to concurrent or sequential punishment by FINRA, the SEC, and state courts for the same offense.[100] FINRA's dispute resolution processes leave brokers' due process rights curtailed at both ends—in broker-investor disputes, they are subject to the same deprivations as are investors,[101] yet for FINRA-led investigations that are criminal in nature, they are affirmatively denied Fifth Amendment protection.[102]

B. Why FINRA's Processes Fall Short

While the due process deprivations inherent in FINRA processes are especially unjust to investors because they are forced to sign the contracts,[103] the shortcomings described in this section apply to brokers as well—they are bound by the same pre-dispute arbitration clauses as investors.[104] This Part will review the three largest deficiencies in FINRA's arbitration proceedings: lack of transparency,[105] disputants' inability to be heard,[106] and lack of impartiality.[107] It will proceed to explain, in turn, how each of these deficiencies deprives disputants of their due process rights in practice.

1. Lack of Transparency

Although "[o]ne of the pillars of a democratic society is public access to the workings of [the] government,"[108] FINRA processes not only do not require written opinions,[109] but also make it extremely difficult to obtain one upon request.[110] Further, disputants governed

96. *See Get to Know Us*, *supra* note 7, at 6 (giving examples of instances where FINRA has suspended and barred registered representatives for various misdeeds).

97. *Id.*

98. *See* D.L Cromwell Invs., Inc. v. NASD Regulation, Inc., 279 F.3d 155, 162–63 (2d Cir. 2002) (holding that the independent regulatory interest of the NASD allowed them to compel testimony even when doing so in conjuncture with an SEC investigation).

99. *See* Jones v. S.E.C., 115 F.3d 1173, 1183 (4th Cir. 1997) (holding that, because the NASD is a private entity, the government may pursue charges on top of those levied by the NASD).

100. *Id.*

101. *See* Desiderio v. NASD, 191 F.3d 198, 206 (2d Cir. 1999) (explaining that FINRA does not act as a state actor when conducting investigations of its member brokers).

102. United States v. Solomon, 509 F.2d 863, 869 (2d Cir. 1975).

103. Gross, *supra* note 50, at 514.

104. While Part II.D focuses on the developments that forced investors to sign pre-dispute arbitration agreements, both parties sign the contract and are therefore bound by it. *See* McMahon v. Shearson/Am. Exp., 788 F.2d 94, 97–98 (2d. Cir. 1986) (holding that pre-dispute arbitration clauses in the securities context are valid, binding *contracts*) (emphasis added).

105. *Supra* Part II.C.1.

106. *Id.*

107. *Id.*

108. Irwin et al., *supra* note 87, at 1071.

109. FINRA Rule 12514(d).

110. *Id.*; FINRA Rule 12904(g).

by FINRA processes—and the public at large—are deprived of access to information guaranteed to them in governmental proceedings: the Administrative Procedure Act, the Freedom of Information Act, and the Government in the Sunshine Act are all inapplicable to FINRA proceedings.[111] This lack of transparency insulates FINRA arbitrators, invites arbitrary awards, and diminishes disputants' ability to appeal: "Without written opinions, the risk of discriminatory and illegitimate awards is significant . . . . An arbitrator who is obliged to render a reasoned written opinion will be more prudent in evaluating the evidence and less likely to be influenced by bias."[112] Without written opinions, disputants and appeals courts cannot determine the validity of FINRA arbitrators' reasoning, decreasing the possibility of a successful appeal;[113] indeed, without any reasoning whatsoever, it is all but impossible for disputants to determine whether they should appeal to begin with.[114]

Further, the inapplicability of such protections as the Freedom of Information Act[115] precludes disputants from discovering potentially pertinent information about FINRA and their arbitrators.[116] Coupled with arbitrators' discretion to limit discovery in arbitration[117] and FINRA's explicit policies disallowing certain standard basic discovery techniques in arbitration,[118] it is often difficult for disputants to gather any information for their case at the arbitral stage or appeal.[119] Thus, FINRA disputants are deprived of important information on both ends of their claim—it is difficult for them to discover the necessary facts to establish a claim or a potential conflict of interest in their arbitrator for an appeal.[120] Should they succeed in proving the needed facts, there is no way for a disputant to know whether the arbitrator applied those facts to a proper legal analysis without a written opinion, making a reasoned appeal extremely difficult.[121]

2. FINRA May Not Provide a Right to a Hearing

The fact that FINRA arbitrators are free to dismiss claims involving less than

111. Karmel, *supra* note 12, at 183–84.

112. Georgios Zekos, *Realities of Securities Arbitration in the USA Today*, 12 VINDOBONA J. OF INT'L. COM. LAW AND ARB. 33, 52 (2008).

113. Warach, *supra* note 28, at 133.

114. *Id.*

115. Karmel, *supra* note 12, at 183.

116. *See id.* at 184 (explaining that applying these Acts to FINRA could make available to the public information regarding FINRA's "deliberations, rule-making procedures, and disciplinary activities").

117. *See* Richard A. Bales & Sue Irion, *How Congress Can Make a More Equitable Federal Arbitration Act*, 113 PENN ST. L. REV. 1081, 1095 (2009) ("Many courts allow arbitration clauses that give the arbitrator discretion to limit discovery.").

118. *See id.* at 1096 ("FINRA . . . does not allow depositions in arbitration, except in statutory discrimination claims.").

119. *See* Gross, *supra* note 50, at 507−08 (describing the propensity of FINRA arbitrators to dismiss claims at an early stage without litigation-like discovery processes).

120. This is especially troubling because arbitrators have the authority to dismiss claims for failure to state a claim under the Federal Rules of Civil Procedure. *See id.* at 507 (stating that courts will only require an arbitration hearing if the arbitrator's decision not to have one was "fundamentally unfair").

121. *See* Warach, *supra* note 28, at 121 ("The wide discretion that FINRA affords to its arbitrators in conducting arbitrations and the *practical absence of an appeals process* for reviewing Awards prevents SEC oversight—no matter how great—from ensuring that arbitrators fairly administer FINRA's rules.") (emphasis added).

$25,000,[122] even at the pleading stage,[123] is troublesome. It becomes especially worrisome, however, taken in conjuncture with FINRA's other due process deprivations. Given the limited discovery disputants are allowed under FINRA proceedings,[124] it may be impossible for them to put forth a claim that meets the increasingly stringent pleading requirements of the Federal Rules of Civil Procedure.[125]

Further, the potential of partial arbitrators is very real.[126] While this is mostly facilitated by FINRA's lack of transparency, FINRA's policies on hearings and dismissals on the pleadings exacerbate the potential for abuse.[127] Refusal of a hearing along with dismissals on the pleadings disproportionately affect individual investors[128]—they are the most likely to file grievances under $25,000[129] and the least likely to have the ability to hire attorneys to craft a simple pleading document.[130] By denying the right to a hearing, FINRA arbitrators can be left comparing the legal paperwork of laymen to that of sophisticated attorneys representing major firms to the detriment of individual investors. In sum, FINRA's processes not only undercut the basic democratic right to be heard, but they do so with little guarantee that the decision maker will be neutral.[131]

3. FINRA Arbitrators Have Too Many Interests to Remain Completely Impartial

The most troubling aspect of FINRA's arbitration process is the potential for partial arbitrators. Indeed, if FINRA could guarantee that all decisions were made impartially, the necessity for a hearing, transparency, and judicial review would be less pressing. The potential for abuse, however, is extremely high: FINRA is funded by the very businesses it regulates, invests in, and selects its executives from.[132] Indeed, FINRA and its

122. FINRA Rule 12600.

123. *See* Gross, *supra* note 50, at 507 (describing arbitrator's authority to dismiss claims before any hearing).

124. *See* Karmel, *supra* note 12, at 183 (describing the information gathering processes guaranteed to claimants in governmental proceedings yet denied to FINRA claimants).

125. *See* Ashcroft v. Iqbal, 556 U.S. 662, 677–78 (2009) (heightening pleading standards in all cases from "a short and plain statement that the pleader is entitled to relief" to "sufficient facts" in a claim for relief that is "plausible on its face").

126. Even more so in cases involving less than $25,000 because claimants are all *per se* not entitled to public panel protections. *See* FINRA Rule 12403(d) (stating that although all arbitrators are declared "public," the rule is recently enacted and only applies to claims involving three person arbitration panels dealing with claims over $100,000); *see also infra* Part III.B.3 (explaining the various factors that increase the potential for arbitrator partiality).

127. Allowing dismissals at the pleading stage—especially without written justification—allows for the most egregious partiality, and it also decreases the chances of discovering an arbitrator is openly antagonistic, as that could best be uncovered at an early hearing.

128. Ironically, this is the very same constituency FINRA holds itself out as protecting the most. *See Get To Know Us*, *supra* note 7, at Introduction ("FINRA continues that tradition today with a commitment to protect investors through strong enforcement and effective investor education.").

129. While $25,000 is often a significant sum to the individual investor, it is not for the multi-million and billion dollar firms that are FINRA's members. FINRA regulates 4400 firms providing investment services. *Id.* FINRA garners over $800 million annually from those member firms. Irwin et al., *supra* note 87, at 1073. This means that the average firm pays FINRA over $180,000 annually in fees alone—substantially more than the average American income. Steve Hargreaves, *15% of Americans Living in Poverty*, CNN MONEY (Sept. 17, 2013), http://money.cnn.com/2013/09/17/news/economy/poverty-income/.

130. Similarly, the transaction cost of an attorney will be much higher for an individual investor than it is for a firm.

131. *See supra* Part II.D.

132. Irwin et al., *supra* note 87, at 1073.

employees—especially its executives—are compensated quite handsomely by the firms they govern.[133] FINRA's financial stake in the success of the companies it regulates is obvious, as is the potential for impartiality that inevitably follows.[134]

Unfortunately, the potential for partiality has seemingly come to fruition in fact. An investigation of FINRA awards confirms the view of the former chief accountant for the SEC—"[t]he economic incentives are so strong and these executives don't want to make waves and upset the industry."[135] Although these executives are not the arbitrators, studies show these sympathies are reflected in FINRA arbitrators.[136]

The first context in which intra-industry bias becomes apparent is in broker-investor disputes. While 47% of investor claimants succeeded in FINRA arbitration proceedings in 2010,[137] they were only awarded approximately one-third of their claimed damages on average.[138] This number is further eschewed by the fact that several large awards substantially increase the mean award,[139] and those awards tended to come primarily from punitive damages.[140] The mean award for all claimants from 1986–2008 in arbitration proceedings was one-fourth of one percent of the mean damages claimed.[141] Although these studies find modest success for investor-claimants in receiving some award, they reflect an overall desire by arbitrators not to disrupt the industry in which they are immersed. Except in cases of particularly egregious behavior justifying punitive damages, an investor is extremely unlikely to get an amount close to their claimed damages.[142] In totality, then, arbitrators seem willing to award minimal amounts of damages for valid claims—an amount that will have no real affect on the bottom line of the industry's major firms.[143] Arbitrators, however, seem much more reluctant to rule against repeat players—those that could negatively affect the market after an adverse FINRA ruling.[144]

A cursory examination of FINRA awards reveals that major industry players rarely feel the brunt of FINRA enforcement.[145] Lipsky's study found that "[t]he top ten firms had

133. *See id.* at 1073–74 (explaining that FINRA received almost $800 million from its member firms, that 66.9% of its $540,300,000 operating revenue went to compensation, and that eight of ten FINRA executives received salaries in excess of $1 million).

134. Perhaps the easiest, and most glaring, example of this conflict of interest is that Bernie Madoff was Chairman of the NASD and head of the National Adjudicatory Council, which reviews FINRA disciplinary actions while he was conducting his Ponzi scheme. *See id.* at 1075.

135. *Id.* at 1073 (citing Alexis Leonidis & Zeke Faux, *Investors May Lose as Congress Saves Money on Adviser Oversight*, BLOOMBERG NEWS (June 27, 2011), http://www.bloomberg.com/news/2011-06-28/investors-may-lose-as-congress-saves-money-on-adviser-oversight.html).

136. *See e.g.*, Warach, *supra* note 28, at 130 ("Empirical research may confirm industry affiliates' tendency to side with brokers or brokerage firms in securities disputes."); *see also infra* Part II.B.3 (examining the outcomes of FINRA proceedings and determining they reflect favoritism to major industry players).

137. Irwin et al., *supra* note 87, at 1076.

138. *Id.*

139. *See* Lipsky et al., *supra* note 18, at 55–56 ("The 10 largest awards accounted for 22% of the total, and the 20 largest cases accounted for nearly 30%.").

140. *See id.* (explaining that the largest award since 1986 was for $27.6 million, $25 million of which was punitive).

141. *Id.* at 56.

142. *Id.*

143. Laurie P. Cohen & Kate Kelly, *NYSE turmoil Poses Question: Can Wall Street Regulate Itself?* WALL ST. J. (Dec. 31, 2003), *available at* http://online.wsj.com/articles/SB107282097396518500 (access required).

144. *See id.* (discussing criticisms of the self-regulatory system including the tendency to only target individuals rather than companies).

145. *See* Lipsky et al., *supra* note 18, at 57 (finding that major, repeat players succeed in FINRA arbitration

a win rate of 46.7%, while the top five had a win rate of 50.2%. The win rate for all other firms was 35%."[146] Further empirical studies confirm arbitrators seemingly give preference to major industry actors.[147] Lending further credence to this preference is the fact that the majority of regulatory cases brought by FINRA have been against individual brokers, as opposed to major market players.[148] FINRA targets "the little guy, sparing the big, deep-pocketed members that wield clout at the marketplaces."[149] Thus, evidence suggests that FINRA arbitrators not only give preference to brokers as a class over investors but also target those brokers that will least negatively influence the securities industry in which FINRA has invested.

C. Balancing Interests: Can FINRA's Current Enforcement Regime Be Justified?

Familiar is the balancing test employed when substantive or procedural fundamental rights, such as due process, are deprived by state actors—that is, such deprivations may be justified if the state has a compelling interest in doing so.[150] Although FINRA is clearly not a state actor when constitutional violations are claimed,[151] because of its quasi-judicial and quasi-regulatory functions, a similar analysis is nonetheless appropriate. That is, if FINRA's dispute resolution processes and overall regulation have proven particularly effective, perhaps society would have a compelling interest in having them remain as is. Unfortunately, many of the purported benefits of arbitration have proven unobtainable under FINRA,[152] while they have simultaneously failed in their regulatory duty to protect investors.[153]

FINRA arbitration proceedings do not adequately promote efficiency, fairness, or expense to a level that justifies the due process deprivations in its processes. The average time between a claim's filing and judgment in FINRA proceedings is approximately 17 months.[154] This time span does not include potential appeals.[155] Further, on average, FINRA proceedings take longer than arbitration proceedings brought through the American Arbitration Association.[156] Expediency, then, seems an inadequate justification

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substantially more than individual employees).

146. *Id.* at 58.

147. *See id.* at 57 (citing Lisa B. Bingham & Shimon Sarraf, *Employment Arbitrations Before and After the Due Process Protocol for Mediation and Arbitration of Statutory Disputes Arising Out of Employment: Preliminary Evidence that Self-Regulation Makes a Difference, in* ALTERNATIVE DISPUTE RESOLUTION IN THE EMPLOYMENT ARENA 303–29 (Samuel Estreicher & David Sherwyn eds., 2004)) (finding a 29% win rate in arbitration proceedings for employee disputants when the claim involved a repeat player and a 62% win rate when it did not)).

148. Pacella, *supra* note 13, at 224.

149. Cohen & Kelly, *supra* note 143.

150. *See, e.g.*, Washington v. Glucksburg, 521 U.S. 702, 721 (1997) (explaining that when a state attempts to curtail a fundamental right, it must have a compelling interest for doing so).

151. Desiderio v. NASD, 191 F.3d 198, 206 (2d Cir. 1999); United States v. Solomon, 509 F.2d 863, 869 (2d Cir. 1975).

152. *See infra* Part II.C (explaining how many of the purported benefits of FINRA arbitration have not come to fruition).

153. *See* Pacella, *supra* note 13, at 223 (outlining FINRA's regulatory failures).

154. Lipsky et al., *supra* note 18, at 57.

155. *Id.*

156. *Id.*

for due process deprivations. Given the potential for partiality,[157] lack of transparency,[158] lack of satisfactory appeals,[159] and potential refusal of a hearing,[160] it is difficult to see how FINRA's processes advance a "compelling" societal interest in guaranteeing fairness. Lastly, expense to disputants seems an implausible justification—not only do disputants have to pay attorneys' fees throughout arbitration proceedings, but they may be forced to pay substantial amounts for written opinions.[161]

Of more concern, however, is that FINRA has utterly failed to protect investors from serious securities violations while employing these processes.

> FINRA has also been accused of failing to uncover the most significant financial scandals that have occurred in recent years. FINRA allegedly failed to adequately supervise the capital requirement compliance of Lehman, Bear Sterns, and AIG; to uncover Bernard Madoff's Ponzi Scheme; and to adequately respond to information allegedly received by FINRA from five sources that Stanford Financial Group was engaging in fraud. Such failures resulted in so much harm for investors that FINRA's board appointed a special review committee to investigate FINRA's examination procedures[.][162]

Thus, while the implementation of FINRA's arbitration procedures has failed to provide any discernible benefits to disputants, the SRO has utterly failed in its regulatory functions. It appears FINRA's two potential compelling interests—that its processes either offer a superior form of dispute resolution or enhance its regulatory capabilities—have proven illusory.

D. Forcing Investors Into FINRA's Arbitration Process

Given FINRA's lack of procedural safeguards, it seems unlikely that any investor would want their claim resolved through FINRA arbitration. Yet because pre-dispute arbitration clauses in securities contracts are now enforceable[163] and are universally contained in brokerage contracts,[164] almost all investor-claimants find themselves subject to FINRA proceedings. This section focuses on why these contracts are adhesive and therefore unenforceable.[165]

Before determining whether pre-dispute arbitration clauses in broker-investor contracts are adhesive, it is first necessary to examine what an adhesive contract is:

> Adhesion contracts have two elements. First, they are drafted by a stronger party and the weaker party . . . has no opportunity to negotiate any of the substantive terms. Second, the adhering party has no realistic opportunity to look elsewhere for the goods or services needed . . . . He is 'required by the realities of business[]

157. Irwin et al., *supra* note 87, at 1071.
158. Zekos, *supra* note 112, at 52.
159. *Supra* Part III.B.1.
160. FINRA Rule 12403(d).
161. FINRA Rule 12904(g).
162. Pacella, *supra* note 13, at 223.
163. Shearson/Am. Exp. v. McMahon, 482 U.S. 220, 226 (1987).
164. *See e. g.* Bales & Irion, *supra* note 75, at 1082 (". . . pre-dispute arbitration agreements are now widely used for consumer contracts and many employment agreements.").
165. *Infra* Part III.D.

to use the standard-form contract that the stronger party requires.[166]

A cursory examination of broker-investor contracts leads to the conclusion that they indeed meet these criteria. Undoubtedly, the individual investor is much less powerful than the brokerage firms crafting these contracts. Further, given that pre-arbitration dispute clauses are universal in broker-investor contracts[167] the "realities of business" provide no opportunity for the investor to "look elsewhere" for brokerage contracts without arbitration requirements.[168] However, for a court to invalidate a contract on grounds of adhesion, a disputant must also prove the terms of the agreement are oppressive in nature.[169] The *McMahon* Court rejected the plaintiff's adhesion argument on this ground, assuming that a disputant forced to arbitrate through an SRO sacrificed no "substantive rights."[170] As is clear, however, the Court's reasoning was flawed in this assumption.

Despite the *McMahon* Court's proclamation to the contrary, every party involved in FINRA dispute resolution proceedings must sacrifice substantive rights.[171] Brokers must sacrifice their Fifth Amendment rights to refrain from self-incrimination[172] and Double Jeopardy protection.[173] Investors must sacrifice some of the core protections of due process—the right to be heard,[174] right to receive written opinions,[175] and right to an impartial decision maker.[176] Further, brokerage firms are not even required to explain to investors the terms of the pre-dispute arbitration contract.[177] Even the SEC's "favorable view of SRO arbitration" was predicated on the fact that arbitration was not mandatory.[178] Perhaps the *McMahon* Court was hopeful that SROs would adopt due process procedures substantially similar to those guaranteed to disputants in governmental procedures. It has become clear, however, that FINRA's arbitration procedures fall far short of that—36 years of holdings confirming *Mitsubishi*'s basic rationale simply ignore the realities of securities contracts. Courts now seem more concerned with continuing to endow arbitrators with "super status"[179] at the expense of investors' basic constitutional rights.

IV. RECOMMENDATION

FINRA's dispute resolution and arbitration processes deprive disputants of significant safeguards, yet the implementation of these processes has not advanced FINRA's effectiveness in either its quasi-judicial or regulatory capacities. Even so, attempts to put

166. J. Kirkland Grant, *Securities Arbitration: Is Required Arbitration Fair to Investors?*, 24 NEW ENG. L. REV. 389, 452 (1989).

167. Gross, *supra* note 50, at 515.

168. *See Get To Know Us, supra* note 7, at 7 (explaining FINRA's monopolistic control over brokers).

169. Grant, *supra* note 166, at 452.

170. Shearson/Am. Exp., Inc. v. McMahon, 482 U.S. 220, 229–30 (1987).

171. *Supra* Part III.D.

172. Desiderio v. NASD, 191 F.3d 198, 206 (2d Cir. 1999).

173. United States v. Solomon, 509 F.2d 863, 869 (2d Cir. 1975).

174. FINRA Rule 12600.

175. FINRA Rule 12403(d).

176. Irwin et al., *supra* note 87, at 1073−75.

177. Grant, *supra* note 166, at 455–56.

178. *See* Gross, *supra* note 50, at 514 ("However, the SEC's favorable view of SRO arbitration . . . was conditioned on its then current belief that firms' use of arbitration clauses in customer agreements was not universal . . . . That change in support has not yet happened even though arbitration is now considered mandatory for universal investors.").

179. *Id.* at 495.

securities regulation into the hands of public entities have been unsuccessful, and the executive branch has shown equally little enthusiasm for change.[180] Because of FINRA employees' inherent conflicts of interest[181] and their ability to freely employ, or not employ, procedural safeguards as they see fit,[182] all with virtually no accountability,[183] substantial changes to FINRA's dispute resolution processes are unlikely to come from within. Moreover, even internal change fails to resolve perhaps the most pressing concern for individual investors—that mandatory pre-dispute arbitration clauses force them into FINRA regulation.[184] Two potential developments then—one judicial, one legislative—may protect investors' and brokers' due process rights while simultaneously allowing FINRA to enhance its regulatory effectiveness. First, given that the central assumption of the *McMahon*—and therefore *Mitsubishi*—Courts has proven illusory,[185] the Court should reverse course and conclude that mandatory broker–investor, pre-dispute arbitration clauses are unenforceable, at least until legislative action guarantees to disputants the substantive rights the *McMahon* Court presumed they would retain.[186] Separate from, or in conjunction with, such judicial intervention, Congress should remove from FINRA's authority all dispute resolution, thereby assuring disputants more substantial due process rights and freeing FINRA resources to protect investors from egregious securities violations.

A. Overturning McMahon

While the Supreme Court is hesitant to overturn[187] prior precedent, it nonetheless will make exceptions when the fundamental premise its previous decision was predicated upon has proven incorrect.[188] The notion that investor-disputants do not forfeit any substantive

180. *See* Shapiro, *supra* note 26, at 2 (explaining that "the executive branch, including the SEC, has failed to hold SROs accountable for their self-serving behaviors").

181. *Supra* Part III.B.3.

182. *See supra* note 88 and accompanying text (describing the flexibility FINRA has in adjudicatory proceedings).

183. Warach, *supra* note 28, at 121.

184. Gross, *supra* note 50, at 515.

185. *See* McMahon v. Shearson/Am. Exp., 482 U.S. 220, 229–30 (describing that the *McMahon* Court's reasoning for enforcing broker-investor disputes was because disputants in such arbitration sacrificed no substantive rights).

186. *Id.*

187. In using the phrase "overturn" this recommendation refers to *McMahon*, a circuit court decision, and recognizes that the stare decisis requirements outlined do not directly apply. However, because the rationale of the *McMahon* court was so intricately tied to the Supreme Court's rationale in *Mitsubishi*, this section assumes that the *Mitsubishi* rationale will have to be overturned as well. *See generally* McMahon v. Shearson/Am. Ex., Inc., 788 F.2d 94 (2d Cir. 1986); Mitsubishi Motor Corp. v. Soler Chrysler-Plymouth, 473 U.S. 614, 628 (1985). *McMahon*, however, specifically applies the *Mitsubishi* rationale to pre-dispute arbitration clauses in broker-investor securities contracts and remains good law. *See generally McMahon*, 788 F.2d 94; *Mitsubishi*, 472 U.S. 614. Thus, this section's recommendation proceeds as if the Supreme Court must overturn itself because of the implicit recognition that overturning *McMahon* is not possible without simultaneously overturning *Mitsubishi. See generally McMahon*, 788 F.2d 94; *Mitsubishi*, 472 U.S. 614.

188. *See* Citizens United v. Fed. Election Comm'n, 558 U.S. 310, 362–63 (2010) ("Beyond workability, the relevant factors in deciding whether to adhere to the principals of stare decisis includes the antiquity of the precedent, the reliance interests at stake, and of course whether the decision was well reasoned. We have also examined whether experience has pointed up the precedents shortcomings.") (internal quotations omitted); *see also* Garcia v. San Antonio Metro. Transit Auth., 469 U.S. 528, 557 (1985) ("We do not lightly overrule recent precedent.").

rights by being forcibly subjected to FINRA arbitration is simply no longer tenable.[189] Although this in no way guarantees the Supreme Court will reverse course from *McMahon*, it at least gives it the necessary precedential ability to do so.

Having concluded that overturning *McMahon* is possible, this Note now explores the substantial policy reasons for doing so. Most immediately, overturning *McMahon* will guarantee a heightened form of due process to those investors and brokers who otherwise would be forced into the arbitration process. While this may temporarily deprive investing parties of their non-fundamental right to contract,[190] such a deprivation is necessary to protect the fundamental rights of due process.[191] Further, such broad judicial anti-enforcement could easily be short-lived. Congress could pass legislation guaranteeing that pre-dispute arbitration clauses in the securities industry were neither mandatory nor universal.[192] Such legislation could require that all investor–broker disputes come absent such clauses and that investors knew those facts. In this regime, the bargaining power between the two parties would be equal, and any arbitration clause arrived on would be enforceable.

At the very least, in response to such a ruling FINRA would be forced to substantially alter its dispute resolution processes to assure the supposition of the *McMahon* Court actually occurs.[193] That is, if FINRA arbitration proceedings truly did not deprive investor disputants of any substantive rights, then the *McMahon* rationale would hold true. While protecting those substantive rights would simultaneously require increased SEC and judicial oversight, it would force FINRA to adopt due process requirements similar to those of a state actor to retain authority in investorbroker disputes. Investors would at least be assured that courts would not enforce mandatory arbitration clauses until they were assured of state-like due process rights once within the gambit of FINRA's authority.

189. Numerous examples implicating substantive rights exist in the current regulatory format, such as the aforementioned curtailment of brokers' double jeopardy rights. Jones v. S.E.C., 115 F.3d 1173, 1183 (4th Cir. 1997). Further, brokers do not have a right to a written opinion in a criminal-like proceeding, a right held to be both substantive and fundamental. The more concerning aspect of the *McMahon* rationale, however, is that it fails to distinguish between parties who freely choose to forfeit the basic protections of governmental adjudication and those that are forced to forfeit them. *See McMahon*, 788 F.2d at 96–98 (assuming that all parties simply agreed to the pre-dispute arbitration clause). The former may very well sacrifice only procedural due process rights. The latter, however, are forced to resolve their claims through an entirely private organization with minimal governmental oversight. Forcibly denying Americans access to any sort of governmental adjudication and instead offering a mechanism that inherently poses threats that the decision maker is not neutral can in many ways be thought of as an expanded deprivation of the substantive right to trial by jury.

190. *See, e.g.*, United States v. Carolene Products Co., 304 U.S. 144, 147 (1938) (holding that courts will give only rational scrutiny to economic regulations such as contractual interference, indicating that such a right is not fundamental).

191. *See, e.g.*, Griswold v. Connecticut, 381 U.S. 479, 483 (1965) (holding that fundamental rights are not limited to those specifically mentioned in the Constitution but extend to "periphery" rights, thereby signaling that constitutionally mandated rights, such as procedural due process, are undoubtedly fundamental).

192. While this recommendation primarily focuses on the positive effects such legislation would have on investors, it by no means minimizes the fact that assuredly not every broker wishes to have a dispute with an investor arbitrated by FINRA. In that light, such legislation would allow both investors and brokers, either individually or as part of a firm, to choose their preferred dispute mechanism.

193. That supposition being that mandatory arbitration in broker-investor contracts does not deprive parties of any substantive rights. Shearson/Am. Exp., Inc. v. McMahon, 482 U.S. 220, 229–30 (1987).

B. Removing Dispute Resolution From FINRA's Authority

The second potential solution to the problems created by current FINRA processes is to legislatively remove FINRA's dispute resolution authority altogether. Ideally, this would be in conjuncture with the aforementioned recommendation, but even alone it would be extremely effective in protecting brokers' and investors' due process rights. Further, such a legislative enactment would free FINRA to facilitate its primary goal—to protect the American public from flagrant securities violations, a goal it has failed to attain in significant ways.[194]

While removing FINRA's dispute resolution authority would not necessarily eliminate the adhesive contract issue in the broker-investor agreements, removal would at least shift jurisdiction to other arbitration organizations.[195] This is a significant upgrade for investors for two reasons. First, other arbitrators would not have strong incentives to be partial in their resolution of disputes. Second, other arbitration organizations have more demanding due process standards than does FINRA. Thus, while such a solution may still require investors to arbitrate their claims, they are at least guaranteed a more procedurally fair process and an impartial decision maker.[196]

Significantly, this proposed remedy offers protections for brokers that declaring all pre-dispute arbitration clauses unenforceable does not. Brokers under FINRA investigation for potential violations are also subject to the due process deprivations in FINRA's dispute resolution process in criminal-like proceedings.[197] Removing investors from FINRA's authority by overturning *McMahon* does little to help the individual brokers who are deprived of their due process rights should they be accused of a violation. Conversely, removing dispute resolution proceedings in their entirety from FINRA's authority would protect brokers' rights through adjudication or a substantially more equitable arbitration proceeding.[198] While the due process deprivations of brokers in FINRA proceedings are arguably less egregious than those to investors because brokers choose to enter the industry knowing the regulatory environment, this recommendation nonetheless addresses a pressing concern.

Lastly, removing dispute resolution proceedings from FINRA's authority would allow FINRA to do its job. While there is of course no guarantee such removal would result in enhanced investor protection, it makes no sense to allow FINRA to retain jurisdiction over individual disputants when they have failed to detect several of the most egregious securities violations of the last five years.[199] While there seems little upside in maintaining FINRA's dispute resolution authority, clearly there is a large downside should FINRA continue to fail in its regulatory capacity. Perhaps allowing FINRA to focus on flagrant securities violations that affect the lives of millions will prevent future catastrophic losses. Should it continue to fail in this task, it will be difficult not to question the utility of FINRA altogether.

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194. Pacella, *supra* note 13, at 223.

195. Other arbitration organizations include the American Arbitration Association or the National Arbitration Forum. Gross, *supra* note 50, at 507.

196. This is almost inarguably the most pressing problem with FINRA's control over securities arbitration.

197. *Supra* Part III.A (describing said due process deprivations).

198. Given FINRA's propensity to target violators who do not disrupt the market, amongst other reasons, it is likely that many brokers would prefer an arbitrator outside of the industry.

199. Pacella, *supra* note 13, at 223.

V. CONCLUSION

Investors wishing to invest through brokerage firms are forced to sign pre-dispute arbitration contracts, through which they are forced into FINRA's arbitration process. Because FINRA is a private SRO, its arbitration process omits several cornerstone due process protections, such as the right to be heard, transparency, and guarantee of an impartial decision maker. With little oversight from either the SEC or the judiciary, FINRA is unlikely to change its processes internally—even if it did choose to do so, there is no guarantee individual arbitrators would follow protocol. Because of this, investor due process rights must be protected through external change. The first potential way to protect disputants is by the Supreme Court overturning *McMahon* and holding mandatory pre-dispute arbitration clauses in securities contracts per se unenforceable. The second way is for the legislature to remove broker-investor dispute resolution from FINRA's authority, thereby allowing investors to freely choose their preferred arbitral body and freeing FINRA resources to more effectively regulate the securities industry. While these solutions would work best in conjunction, either one would be a step in the right direction.