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Is It Time to Revisit SEC's Ban on "Forced" Arbitration Provisions?

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The SEC has long refused to allow companies to go public with bylaws or other governing documents that would require shareholders to arbitrate federal securities law claims against the company. But there also has been considerable doubt over the SEC's position, at least since the late 1980s when the Supreme Court upheld the enforceability of similar provisions in broker-dealer customer agreements.

Nevertheless, the SEC has rarely had to defend its position. It was challenged, albeit somewhat tepidly, in 2012 when a major private equity firm attempted an initial public offering (IPO) with mandatory arbitration provisions. The firm quickly resolved to remove the offending provisions from its governing documents after facing opposition from the SEC staff as well as certain advocacy groups and lawmakers.

The SEC itself, however, has not been without its own skeptics. Last year, for example, then-SEC Commissioner and Acting Chairman Michael Piwowar was reported to have invited public companies to approach the SEC on the subject. Then, in January 2018, it was reported that the SEC was laying the groundwork for possibly reconsidering its position in order to help incentivize more IPOs and thus reverse a downward trend in the number of U.S. IPOs.

This raised the ire of certain lawmakers who wrote SEC Chairman Jay Clayton in March, admonishing him to reaffirm the agency's long-held position. But the Chairman demurred in an April letter back to lawmakers in which he noted the complexity and importance of the issue. He also highlighted differing agency practices where, outside the IPO context, the SEC has not objected, for example, to the use of mandatory arbitration provisions in governing documents by foreign issuers that have listed stock on U.S. exchanges or by companies conducting exempt Regulation A offerings. He did affirm to the lawmakers, however, that the issue was not a priority for him personally and that he expected any decision on the issue would involve the full Commission (rather than the SEC staff acting pursuant to delegated authority) and would be made "in a measured and deliberative manner."

In addition, SEC Commissioner Hester Peirce has expressed skepticism of the SEC's historic position. To her, the issue is largely whether the SEC is justified in substituting its judgment for that of duly informed investors. In recent public remarks, for instance, she emphasized the anomaly of the SEC's opposing mandatory arbitration provisions when used in the IPO context, but not when used by foreign companies that list their securities on U.S. exchanges. The propriety of mandatory arbitration provisions is, according to Peirce, the kind of issue that has generally been the province of state corporate law. She also questioned why the result should be different in the securities law context, as compared with other regulatory contexts in which the Supreme Court has upheld arbitration agreements – as it did most recently last May in *EPIC Systems Corp. v. Lewis*. In that case, the court held that the National Labor Relations Act (NLRA) does not prohibit mandatory arbitration provisions in employment agreements. Notwithstanding a contrary interpretation of the act by the National Labor Relations Board, the court found no "conflicting command" under the NLRA to the general directive under the Federal Arbitration Act that courts enforce arbitration agreements according to their terms. As there are no federal securities statutes expressly conflicting with this directive, the SEC, if challenged, may ultimately be hard pressed to defend its ban on mandatory arbitration provisions in governing documents.

The issue is not without relevance to variable insurance product offerings, as product issuers are subject to much of the same securities regulation as issuers in traditional IPOs. Given the considerable and arguably growing controversy over the SEC's position, now would be a good time for the SEC to revisit the issue forthrightly.

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