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Regulatory Update

SEC Issues Policy Statement on Mandatory Arbitration Provisions in Governing Documents

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On Sept. 17, the Securities and Exchange Commission (SEC) issued a Policy Statement stating that the SEC would henceforth declare effective registration statements of companies that provide for mandatory arbitration of disputes between investors and that company arising under the federal securities laws. This is a clear shift from the SEC's stated position over many years that such mandatory arbitration provisions violate federal securities laws. The SEC's new position reflects its desire to lower barriers to capital formation by reducing the expenses incurred by public companies from shareholder class action lawsuits. The extent to which companies adopt this approach remains to be seen.

Background

Disputes between shareholders and companies can arise under a variety of laws, primarily the corporate laws of the jurisdiction of incorporation of the company and federal securities laws. Federal securities law claims can be brought against a company as "class actions," enabling a single shareholder plaintiff to represent all similarly situated shareholders of the company. The law recognizes that class actions can offer significant efficiencies to a group of plaintiff shareholders (and their lawyers who bear the costs of litigation). Given that fee shifting is rare in the United States, class actions have become a popular litigation tool for the plaintiff's bar in the United States, with the predictable result that securities class actions have become a "cost of doing business" for public companies in the United States.[1]

The question has been raised over the years on whether requiring plaintiffs to bring securities law claims in arbitration could deter securities class action suits by increasing the cost of litigation to plaintiffs and the plaintiff's bar. This is because certain arbitration provisions can prevent shareholders from jointly pursuing their claims and instead require each shareholder to bring a separate arbitral proceeding, where the parties are required to pay the fees of one or more arbitrators (which can be significant) as well as administrative costs charged by arbitral institutions (which also can be significant).

In a series of rulings over the last 15 years, the U.S. Supreme Court has interpreted the Federal Arbitration Act (FAA) to permit class action waivers in arbitration agreements. The Supreme Court also has held that, even absent a waiver, a party cannot be compelled to arbitrate on a class action basis unless there is an affirmative contractual basis to conclude that the party agreed to do so. Such decisions are further to longstanding Supreme Court jurisprudence underscoring the strong U.S. federal policy favoring arbitration, as well as the fundamental importance of consent as a cornerstone to arbitration.

Nevertheless, for over 30 years, the SEC has taken the position that, by foreclosing access to a judicial forum, mandatory arbitration of investor-issuer disputes is inconsistent with federal securities laws. In addition, as a matter of public policy, the SEC viewed such provisions as impeding the ability of investors to bring private actions to enforce their rights under federal securities laws.

As a result, the SEC refused to declare effective the IPO registration statements of at least two companies[2] until such provisions were removed. In addition, the SEC supported a handful of public companies in excluding shareholder proposals from their proxy statements seeking to amend the companies' bylaws to include a mandatory arbitration provision.

The SEC's New Position

The SEC has now concluded that Supreme Court decisions related to the FAA warrant a conclusion that mandatory investor-issuer arbitration provisions do not violate federal securities laws. The SEC cited, in particular, two Supreme Court decisions from 1987 (*Shearson/American Express, Inc. v. McMahon*) and 1989 (*Rodriguez de Quijas v. Shearson/American Express, Inc.*) that permitted the enforcement of arbitration provisions between broker-dealers and their customers, notwithstanding anti-waiver language in the Exchange Act and the Securities Act of 1933 (the Securities Act). In each case, the Supreme Court held that these anti-waiver provisions apply only to substantive rights under the Exchange Act and Securities Act, and that these rights are not undermined by recourse to arbitration as an alternative to litigation. Although these decisions did not address issuer-investor arbitrations, the SEC has now taken the position that there is no substantive difference. The SEC took note of further Supreme Court jurisprudence establishing that federal statutes enacted after the FAA — which includes the federal securities laws — can override the FAA only if there is a clearly expressed congressional intent to do so. The SEC has concluded that it can discern no such clear intent in the federal securities laws.

As such, the SEC no longer considers the existence of a mandatory investor-issuer arbitration provision in a registrant's governing documents as a reason to deny the effectiveness of the registrant's IPO registration statement, provided the registration statement contains adequate disclosure, including regarding the arbitration provision.

Practical Implications

- Companies conducting IPOs are now free to include mandatory investor-issuer arbitration provisions with respect to U.S. federal securities law claims in their governing documents. It remains to be seen whether such provisions will be material to investors' decisions on whether to invest in the company.

- To minimize the risk of a class action or other mass claim scenario in arbitration, investor-issuer arbitration agreements also should include express waiver provisions. Class action arbitration could otherwise still potentially be available and has been supported in recent years by a number of leading arbitral institutions.

- The SEC's position is not limited to IPOs, with it stating that it will not object to public companies amending their governing documents to include an issuer-investor mandatory arbitration provision. For many companies, such a provision could be adopted by board action amending the company's bylaws without the need for a shareholder vote. One can expect, however, that investors may register their objections to such an amendment when voting for directors at annual meetings and proxy advisors will likely consider that a reason to vote against director nominees.

- Companies should still consider the implications of state law because the treatment of state law corporate claims remains separate from federal securities law claims. As one example, Delaware adopted a provision which effectively prohibits the inclusion of mandatory arbitration provisions in the governing documents of Delaware-incorporated companies.[3] The SEC noted potential

uncertainty as to the intersection of the FAA and state law and expressly disclaimed any position on the issue.

- In contrast to questions arising under U.S. state law, certain offshore jurisdictions may offer companies a higher degree of certainty that a mandatory investor-issuer arbitration provision addressing corporate law claims is enforceable. This could make those offshore jurisdictions attractive to public companies or those undertaking IPOs. Other jurisdictions may even seek to attract capital by reducing frivolous claims while still permitting shareholders to take collective action. For example, in the U.K., long established cost-shifting principles create jeopardy for parties bringing frivolous claims, thereby risking adverse costs orders. In addition, the powers of the courts through, for example, Group Litigation Orders (GLOs) permit joint management of claims that share common or related issues of fact or law. Unlike U.S. class actions, GLOs require parties to "opt in" by making their own claim, which are then grouped together by an application to the court. The courts retain strong case management controls, typically looking to resolve issues that are common to the various claims within the group, so that they are binding on the others.

- It has been suggested that the balance of equities may be best served by a hybrid approach that allows a court of first instance to hear a motion to dismiss in a securities class action claim. Only if the claim survives a motion to dismiss would it be subject to arbitration. The is the time when the most significant costs are incurred. Then, the ultimate ruling of the arbitral panel could be reviewed by a court applying an abuse of discretion standard. Any such arrangement would be the product of investor input and careful drafting of the arbitration provision. (See Bradley J. Bondi, "Facilitating Economic Recovery and Sustainable Growth through Reform of the Securities Class-Action System: Exploring Arbitration as an Alternative to Litigation," *Harvard Journal of Law and Public Policy* (Spring 2010).)

- Finally, if companies succeed in adopting mandatory arbitration of shareholder claims (with corresponding class arbitration waivers), the onus of investigating and enforcing U.S. federal securities law disclosure violations could shift to the SEC; however, at this time, the SEC has indicated that it is focused primarily on "[holding] accountable those who lie, cheat, and steal."

Sidebar — Limit on the Impact of Class Actions

A range of events and practices have developed to limit the impact of securities class action lawsuits:

- Legislative developments have made it harder for claims to survive a motion to dismiss. Among other things, the Private Securities Litigation Reform Act of 1995 (PSLRA) requires plaintiffs to identify each allegedly misleading statement and explain why it was misleading, along with facts supporting a strong inference of the defendants' fraudulent intent. The failure to meet these standards results in dismissal.

- Companies have increasingly included in their bylaws a requirement that claims made pursuant to the Securities Act may be brought only in U.S. federal court rather than state courts. Federal courts have often been viewed by companies as more neutral and reliable arbiters. Claims under the Securities Exchange Act of 1934 (the Exchange Act) may only be brought in U.S. federal court as a matter of statute.

- Companies have sought to require that state corporate law claims be brought only in the state of incorporation of the company.

The U.S. Supreme Court has held in *Morrison v. National Australia Bank Ltd*. that the Exchange Act does not apply extraterritorially, protecting certain foreign issuers from securities law claims based on foreign transactions, and decisions interpreting *Morrison* from the U.S. courts of appeals for the 2nd and 9th Circuits have made it more challenging for plaintiffs to sustain Exchange Act claims against foreign issuers.

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[1] According to Stanford Law School, the volume of federal securities class actions filed over the past five years is as follows:

- 2021: 212
- 2022: 197
- 2023: 213
- 2024: 222
- YTD 2025: 129

[2] U.S. Sec. & Exch. Comm'n, Div. of Corp. Fin., Comment Letter to The Carlyle Group L.P. (Feb. 3, 2012), https://www.sec.gov/Archives/edgar/data/1527166/000000000012006433/filename1.pdf. Franklin First Financial Corporation included a mandatory arbitration provision in its charter and bylaws in 1988 in advance of its IPO, and the SEC also refused to accelerate effectiveness of their registration statement.

[3] Section 115(c) of the Delaware General Corporation Law provides that a Delaware incorporated entity can include a provision in its governing documents prescribing one or more forums or venues for certain claims that are not internal corporate claims, so long as stockholders can bring claims in at least one court within the state that has jurisdiction over such claims.