Mandatory arbitration clauses in registered investment advisor agreements draw scrutiny from regulators

By Roger E. Barton, Esq., Barton LLP

JANUARY 4, 2024

On Dec. 5, 2023, the Office of the Investor Advocate (OIAD) published its Report on Activities for the Fiscal Year 2023, an annual report it submits to Congress regarding the Office's research activities and policy recommendations concerning investor interests and welfare.

The project concluded with a recommendation from the OIAD that the SEC consider temporarily suspending the use of all *mandatory arbitration clauses in advisory agreements.*

The OIAD is an independent office within the Securities and Exchange Commission (SEC), created by Congress "to provide investors with a voice inside the Commission, to assist retail investors, to study investor behavior, and to support the Investor Advisory Committee of the Commission" (https://bit.ly/477zYjS).

For 2023, one of the two primary research projects undertaken by the OIAD was investigating the use of mandatory arbitration clauses in agreements between retail investors and SEC-Registered Investment Advisors (RIAs). The project concluded with a recommendation from the OIAD that the SEC consider temporarily suspending the use of *all* mandatory arbitration clauses in advisory agreements.

The project was largely based on a study undertaken by the OIAD earlier this year and published in June (Mandatory Arbitration Among SEC-Registered Investment Advisers / H.R. REPT. NO. 117-393). The study and subsequent analysis set out to evaluate various factors associated with mandatory arbitration clauses in the investment advisory context.

In studying a sample of 579 investment advisory agreements, the OIAD estimated that 61% contained mandatory arbitration clauses. Of advisory agreements with these clauses, a large majority (92%) also dictated the dispute resolution forum which would be used, the most popular being the American Arbitration Association (AAA). Additionally, 60% of agreements with mandatory arbitration clauses designated the arbitration venue — of these, only 3% took into account the client's location.

However, there was a large gap in the research data noted by the OIAD. Because of the private nature of arbitration and the limited arbitration disclosure requirements for RIAs, the OIAD noted that there was a deficit in publicly available information regarding advisor arbitration. Because of this, the OIAD could not identify a sample of advisory clients that could provide an accurate, representative viewpoint of how mandatory arbitration clauses and terms affect retail investors.

In lieu of such a group, the study had to rely on the opinions and anecdotes of stakeholder groups with ties to this issue, such as the American Association of Individual Investors, FINRA Dispute Resolution Services, Financial Services Institute, Public Investors Advocate Bar Association, and others.

Another gap in the data was a lack of reliable statistics concerning how often mandatory arbitration actually occurs pursuant to an advisory agreement. This is largely because SEC-registered advisors are not specifically required to disclose instances of arbitration.

While none of the stakeholders involved in the study denied that the pros of mandatory arbitration (see table below) serve to benefit advisors, some stakeholders maintained that these benefits are enjoyed by *both* parties of a dispute and don't inherently favor the advisor over the client.

Aspect	Pro	Con
Simpler processes, such as limited discovery	Can expedite the process, while protecting sensitive information from discovery	Can prevent a party from accessing potentially helpful evidence
Binding resolutions, with limited opportunities to appeal	Prevents disputes from dragging on through an extended appeals process	Losing party has little recourse if they feel that the decision was biased, unfair, or incorrect.
Privacy from the public	Can shield a party from reputational harm and public scrutiny	Creates less transparency regarding decision-making and outcomes
Predictability when using a familiar forum	Parties can know what to expect when using familiar arbitration forums and/or rules	Forfeits right to a jury trial for a decision by an arbitrator or panel that may or may not have industry experience/ties
Typically faster and more efficient	Can resolve issues quicker and thus be more cost-effective	High arbitrator fees can make this option cost-prohibitive

Graphic created by the author's firm.

Below are some of the advantages and disadvantages of mandatory arbitration, as highlighted by the interviewed stakeholders and the study.

Others asserted that mandatory arbitration is intrinsically more advantageous for RIAs because the agreements and terms therein (e.g., forum, rules, venue, etc.) are determined solely by the RIA, without input or consideration from the client. Additionally, these stakeholders expressed that an RIA and its firm are likely to have more experience with the process of arbitration and a greater ability to absorb the cost of such a proceeding.

In studying a sample of 579 investment advisory agreements, the OIAD estimated that 61% contained mandatory arbitration clauses.

Stakeholders also expressed concern about the latitude for RIAs to include restrictive terms in an agreement limiting the type of claim or amount of an award. However, the OIAD survey found that the occurrences of these types of restrictive provisions in mandatory arbitration clauses were relatively uncommon: class action waivers at 6%, claim limits at 5%, damages limits at 11%, and fee-shifting provisions at 18%.

While these numbers do not suggest widespread intentional "abuse" of such provisions, some of the stakeholders believed that these types of provisions should not be allowed at all, and that RIAs should be held to a standard similar to that of broker-dealers.

For agreements between brokers and their clients, mandatory arbitration clauses are subject to the criteria laid out by the Financial Regulatory Authority (FINRA)'s Code Of Arbitration Procedure For Customer Disputes, which prevents brokers from including mandatory arbitration terms that limit the type of claim or limit the amount of the award. The Code also designates that hearing locations will generally be ones that are close to the client's place of residence, imposes uniform requirements on the number of arbitrators that can sit on a panel, and dictates whether those arbitrators must be public arbitrators.

Brokers are also required to disclose certain arbitration-related information, while SEC-registered advisors are not explicitly required to do so. As part of their fiduciary duty, RIAs are instructed to "make full disclosure to [their] clients of all material facts relating to the advisory relationship" (Form ADV, General Instruction 3 to Part 2). The question of what counts as "material" is left to the advisor's discretion and may or may not include information about arbitration proceedings.

Under the Investment Advisers Act of 1940, the crux of an RIA's fiduciary duty is a duty to act in the client's best interests at all times. The OIAD expressed its belief that limiting the types of claims and amounts of awards in mandatory arbitration agreements likely violates an RIA's fiduciary duty by "mislead[ing] retail clients into not exercising their legal rights."

The OIAD also concluded that when RIAs unilaterally select venue, forum, rules, etc., it can become onerous for the client in terms of convenience and cost, running contrary to the client's best interest.

The study revealed that "stakeholders agreed, to varying degrees, that advisers should consistently be required to disclose more complete information about customer arbitrations and unpaid awards." The SEC heretofore has not explicitly required disclosure of arbitration and any subsequent awards since these do not necessarily implicate an RIA in any wrongdoing, but disclosure of such information could still cause reputational harm in the eyes of the public.

In the conclusion of its analysis, the OIAD has expressed the opinion that not only should restrictive terms be prohibited in mandatory arbitration agreements, but that the SEC should go a step further and consider "temporarily suspending the use of mandatory arbitration clauses in advisory agreements until further exploration of the associated costs and benefits to advisory clients is undertaken." As part of the effort to conduct this exploration, the OIAD is also recommending that RIAs be required to uniformly disclose information related to arbitrations.

Whether the SEC adopts the OIAD's recommendations remains to be seen. If the SEC does not ban mandatory arbitration clauses outright, it seems likely that it will at least consider changes to certain restrictive terms and disclosure requirements related to such clauses. The need for fairness and transparency for investors must be balanced with regulations that are not so overly stringent and burdensome that they become detrimental to advisors. In this instance, the SEC will once again have to decide how to mediate between the two.

Roger E. Barton is a regular contributing columnist on securities regulation and litigation for Reuters Legal News and Westlaw Today.

About the author

Roger E. Barton is the managing partner of New York City-based **Barton LLP** and a litigator. He represents clients in the capital markets and financial services industries regarding securities fraud, breach of fiduciary duty, common-law fraud, 10b-5 class actions, and breach of representations and warranties. He is a fellow of the Litigation Counsel of America and can be reached at rbarton@bartonesq.com.

This article was first published on Reuters Legal News and Westlaw Today on January 4, 2024.