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Virginia proposes abolishing mandatory arbitration clauses

The rule package would also allow senior protection intervention, privacy procedures

David Isenberg August 20, 2019, 1:29 pm

Virginia's security regulator, the **State Corporation Commission**, is looking to ban mandatory arbitration clauses in advisory contracts as part of a package of new measures.

The State Commission said such clauses were "inherently unfair" in its proposal filed in late June with a comment period that ended last week.

"The division believes, as do many other states, that these 'take it or leave it' clauses in client contracts are inherently unfair to investors. It is particularly unfair when an investment adviser is required by law to act in the best interests of their clients," the State Corporation Commission wrote. "An investment adviser should not be allowed to force clients to bring any disputes to a forum of the investment advisor's choosing by contract."

The state regulator added that it viewed boilerplate-like provisions in mandatory arbitration clauses as the problem, and that it was not looking to hamper agreements following arbitrated disputes.

"There is nothing to prevent the investment adviser and their client from agreeing to arbitrated disputes after negotiation and discussion between each," the State Corporation Commission wrote. "To require mandatory arbitration in standard investment adviser contracts is contrary to the investment advisors mandate to act in the best interest of their clients."

Since the comment period ended, the State Corporation Commission received only four comment letters. The **North American Securities Administrators Association**'s letter came out in strong support of the plans to ban mandatory arbitration clauses.

"Forced arbitration at the demand of an investment adviser is inimical to the basic fiduciary nature of an investment advisory relationship," wrote **Michael Pieciak**, president of Nasaa, citing a **Consumer Financial Protection Bureau** report from 2015 that stated that many retail customers aren't aware of forced arbitration agreements and/or their consequences.

"Mandatory arbitration agreements in investment adviser contracts are also contrary to the extensive regulatory oversight of investment advisers," Pieciak added.

The proposed rule package also includes a provision allowing broker-dealers and investment advisers to intervene and refuse transactions or disbursements when there is suspicion of financial exploitation for elder customers, an affirmative duty of investment advisers to adopt information security and privacy policies, and to report unauthorized access to a client's information within three business days of discovery.

Last week, **Finra** sought feedback on potentially revising its own rules related to senior protection, including a potential proposal that would allow Finra members to hold disbursements or transactions when the member reasonably believes the elder client may be impaired, not just in the instance of third-party exploitation.

Nancy Donohoe Lancia, managing director of state government affairs at the **Securities Industry and Financial Markets Association**, wrote a comment letter to Virginia's security regulator primarily in support of the senior provisions. "We believe this new law will provide senior investors greater safe guards," she said.

"NASAA applauds the proposal's various initiatives related to broker-dealer and investment adviser regulation," Pieciak added.

In 2013, the **Massachusetts Securities Division** found in a survey that nearly half of the investment advisers surveyed had mandatory arbitration clauses in their advisory client agreements. "While the division recognizes that arbitration may be appropriate in selected situations, a clause binding an investor to arbitrate a dispute before its circumstances are established may not be in that client's best interests, nor may such a requirement be consistent with the fiduciary duty owed to the client by the investment adviser," the division wrote, asking the SEC to take action.

The majority of mandatory arbitration provisions designate the American Arbitration Association or Judicial Arbitration and Mediation Services as the forum, according to **David Cosgrove**, a partner at **Cosgrove Law Group**. "AAA and JAMS are frequently far more expensive than either Finra or the courts. And in my opinion, they have fewer mechanisms to root out and address natural biases for arbitrators, he added.

Some experts have questioned whether a mandatory arbitration clause violates an adviser's fiduciary duty to their clients, or are unconscionable in any case.

In many advisory agreements, Delaware is the chosen state law that governs the agreement. Delaware state law does not provide for a private right of action arising from investment advice, only for offering, selling, or purchasing a security. Model legislation, the Uniform Securities Act of 2002, establishes civil liability for individuals who willfully commit fraudulent practices related to advisory activity. It has been adopted by 20 states and the US Virgin Islands, but not Delaware.

Cosgrove does not believe, based on experience representing investors and industry, that the model act has substantially expanded adviser liability. "If you are of the opinion that juries are more likely to favor their investor peers, and that paid arbitrators have inherent biases that they can't even identify, let alone neutralize, then the banning of mandatory arbitration creates more liability," Cosgrove said.

Other state regulations

In January, legislators in New York state introduced a bill that would ban mandatory arbitration clauses in a variety of consumer and employment agreements, "including services relating to securities and other investments." The bill is currently in the State Assembly's Consumer Affairs and Protection Committee and hasn't been voted on yet.

A spokesperson for Nasaa said that they were not aware of any other states with a similar provision.

The **Dodd-Frank Act** gave the SEC the option to ban or limit mandatory arbitration agreements in investment advisory contracts "if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors."

In 2013, former **Rep. Keith Ellison** (D-Minn.) introduced a bill to ban mandatory arbitration clauses in advisory and brokerage customer agreements. A similar bill, the Investor Choice Act of 2019, was introduced by **Rep. Bill Foster** (D-Ill.) this year in the House, while **Sen. Richard Blumenthal** (D-Conn.) introduced the equivalent Forced Arbitration Injustice Repeal Act in the Senate. Bills that ban mandatory arbitration clauses are not likely to pass the Republican-held US Senate, added Cosgrove.

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