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SEC commissioner Peirce signals **shareholder arbitration** is not dead yet

Alison Frankel

(Reuters) - Despite the apparent determination of Securities and Exchange Commission Chairman Jay Clayton to avoid the issue of mandatory **shareholder arbitration**, the controversy over whether public companies can require investors to give up their right to sue under federal securities laws just won't die. This week, SEC Commissioner Hester Peirce signaled in a speech to the Council of Institutional Investors that she would support a corporate mandatory arbitration clause, arguing that institutional investors should be more skeptical about the benefits to shareholders of securities class actions.

"The cost of defending and settling these suits is a substantial cost of being a public company," Peirce said. "The result is that the company's shareholders are ultimately harmed by the very option intended to protect them: first by the company's diversion of resources to defend often meritless litigation, and second by the resulting decline in the value of their shares. Case law remains untouched, and the shareholders not involved in the process have no idea what happened."

The SEC commissioner said she "would not insist" on mandatory **shareholder arbitration** provisions for all public companies. But she suggested that if particular corporations were to impose arbitration on investors, shareholders who value the right to sue could simply choose to put their money elsewhere. That's an argument we've heard before from proponents of **shareholder arbitration**, who contend that if companies are permitted to adopt mandatory **shareholder arbitration**, the market will reflect the value of the right to sue in a class action. (Spoiler alert: Arbitration proponents tend to believe that right isn't worth much, if anything.)

Peirce's speech to the Council of Institutional Investors was not the first time she has advocated for **shareholder arbitration**, picking up the mantle from former SEC Commissioner Michael Piwowar. It is, however, her first discussion of the issue since the SEC commissioners sidestepped consideration of the legality of requiring shareholders to arbitrate federal securities claims.

Last month, as you probably recall, the SEC's corporate finance staff told Johnson & Johnson that it would take no action against the company for excluding a shareholder proposal to require investors to arbitrate their federal securities claims. The shareholder proposal for J&J to adopt mandatory arbitration was being pushed by Harvard emeritus law professor Hal Scott, an arbitration proponent who was testing to see if the SEC had softened its historical opposition to **shareholder arbitration** provisions. J&J opposed the proposal. (I know: It seems counterintuitive for a shareholder to propose mandatory arbitration and a company to insist on preserving its investors' right to sue, but this isn't the first time arbitration fans have attempted to force the issue via a shareholder proposal.)

Critics of mandatory **shareholder arbitration**, who've become increasingly worried that the SEC is no longer a reliable ally, mobilized against the J&J shareholder proposal. The Council of Institutional Investors, for instance, sent a letter to SEC Chair Clayton, arguing that securities class actions deter corporate misconduct and complement the agency's enforcement actions. Shunting shareholder disputes into confidential arbitration, CII said, would threaten good corporate governance.

The SEC's corporate finance staff avoided the big question of whether mandatory arbitration is compatible with federal securities laws by deferring to an opinion from the attorney general of New Jersey, J&J's home state, who said such a provision would be illegal under state law. In a separate announcement, Clayton endorsed the staff's handling of the controversy, asserting that a shareholder proposal is not the right context for resolution of an "unsettled and complex" issue.

Clayton's description aside, when Harvard prof Scott asked the corporate finance staff to refer the shareholder proposal to the SEC commissioners, the staff declined. In a Feb. 18 letter, the corporate finance division told Scott that it did not consider the proposal "novel or highly complex" in light of the New Jersey AG's opinion that mandatory **shareholder arbitration** would be illegal.

In this week's speech to the Council of Institutional Investors, Peirce did not specifically disagree with the staff decision on the J&J shareholder proposal. She did, however, posit that if a showdown over a mandatory arbitration provision reached the U.S. Supreme Court, the justices might well hold that the Federal Arbitration Act preempts any purported state-law prohibition on **shareholder arbitration**.

Peirce's criticism of securities class actions invoked many of the usual themes: The cases are inefficient and expensive; they're settled for nuisance value; they punish current shareholders; their primary beneficiaries are lawyers. (The SEC commissioner also said settlements are "rarely public and … involve no publication of broadly applicable legal findings." In fact, class action settlements, as you know, must be approved by federal judges and are thus almost always public.) What's significant about the speech isn't the substance of Peirce's critique of class actions but the context: an SEC commissioner arguing that shareholders shouldn't fight so hard to preserve a right of dubious value.

Peirce is just one commissioner, of course. Her counterpart Robert Jackson, by contrast, has been outspoken in opposition to mandatory **shareholder arbitration**. And chairman Clayton, as I mentioned, has assiduously avoided any commitment to put the issue before the commission. If mandatory arbitration comes to a head in the next few years, it will be at the urging of a company (or a shareholder) that wants to adopt a provision, not because the SEC chair is eager for an opportunity to set precedent.

But Peirce's speech shows the inroads arbitration proponents have already made. Requiring shareholders to give up the right to bring federal securities class actions is no longer a fringe idea debated only among academics. And the SEC may not continue to be a wall of protection for investors' litigation. Peirce's remarks, if nothing else, showed the Council of Institutional Investors that its recent anti-arbitration activism is entirely warranted.

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