



*The Commonwealth of Massachusetts*

*Secretary of the Commonwealth*

*State House, Boston, Massachusetts 02133*

*William Francis Galvin  
Secretary of the Commonwealth*

February 12, 2013

The Honorable Elisse B. Walter  
U.S. Securities and Exchange  
Commission  
100 F Street NE  
Washington, D.C. 20549

The Honorable Troy A. Paredes  
U.S. Securities and Exchange  
Commission  
100 F Street NE  
Washington, D.C. 20549

The Honorable Luis A. Aguilar  
U.S. Securities and Exchange  
Commission  
100 F Street NE  
Washington, D.C. 20549

The Honorable Daniel M. Gallagher  
U.S. Securities and Exchange  
Commission  
100 F Street NE  
Washington, D.C. 20549

Re: Prohibiting the Use of Mandatory Pre-Dispute Arbitration Clauses by  
Investment Advisers

Dear Chairman Walter, Commissioner Aguilar, Commissioner Paredes, and  
Commissioner Gallagher:

As chief securities regulator for Massachusetts, I write to you today regarding a key investor protection issue: investment advisers including mandatory pre-dispute arbitration provisions in their advisory contracts. This practice is more widespread than many observers may have believed. The Massachusetts Securities Division urges the Commission to use its authority under Section 921 of the Dodd-Frank Financial Reform Act to commence a study of investment advisers requiring pre-dispute arbitration; a practice that appears to be inconsistent with the fiduciary duty that advisers owe their customers. The Massachusetts Securities Division offers its experience and resources to assist with any study the Commission may conduct.

The Massachusetts Securities Division recently sent 710 state-registered Massachusetts investment advisers surveys which included questions on the advisers' contracts, and the Division created a report based on the responses received (the "Report"). The survey requested specific information regarding arbitration. Responses were voluntary and anonymous, and response rate was over 50%. In the surveys received, nearly half the investment advisers responded that they include in their advisory contract a binding pre-dispute arbitration clause. I enclose a copy of the Securities Division's Report.

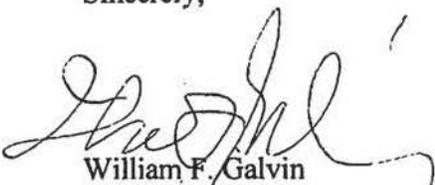
Such widespread use of mandatory pre-dispute arbitration clauses in advisory contracts is troubling and a cause for regulatory concern. By law, investment advisers are required to act as fiduciaries for their clients, with an obligation to act in their best interests. While arbitration may be appropriate in some cases, a clause binding an investor to arbitration before the circumstances are known may not be in the client's best interest nor consistent with an investment adviser's fiduciary duty.

Under the Dodd-Frank Act, which was signed into law on July 21, 2010, Section 921 authorizes and delegates to the Commission the responsibility to reform or prohibit pre-dispute arbitration requirements if the Commission finds that such changes are in the public interest and for the protection of investors. Congress has given the SEC both the tools and a mandate to act in this area.

I urge the Commission to consider making its first step in reform of mandatory arbitration the banning of pre-dispute arbitration language in advisory contracts. At a minimum, the Commission should commence a study of the issues raised by these provisions. It is my opinion that they are inconsistent with the fiduciary duty that investment advisers owe to their clients.

My office stands ready to assist the Commission with any study or information gathering it conducts in this important area. Please contact Bryan Lantagne, Director of the Massachusetts Securities Division at (617) 727-3548 if you have questions or we can assist in any way.

Sincerely,



William F. Galvin  
Secretary of the Commonwealth  
Commonwealth of Massachusetts

Enclosure

# REPORT ON MASSACHUSETTS INVESTMENT ADVISERS' USE OF MANDATORY PRE-DISPUTE ARBITRATION CLAUSES IN INVESTMENT ADVISORY CONTRACTS

*By the Massachusetts Securities Division Staff  
February 11, 2013*

## Introduction

Under the Federal Arbitration Act (the "FAA"), American courts have historically favored the use of pre-dispute arbitration clauses to compel arbitration as an alternative dispute resolution mechanism. In the context of securities law, the U.S. Supreme Court extended the favorable treatment of pre-dispute arbitration clauses in Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987). In McMahon, the Court explained that the FAA generally mandates enforcement of agreements to arbitrate statutory claims in the context of the Securities Exchange Act of 1934, but also explained that, as with any statutory directive, the FAA's mandate may be overridden by a contrary congressional command.<sup>1</sup>

Since McMahon, the use of arbitration has continued to govern a variety of securities-related disputes. A recent development along these lines occurred in October 2012, when the Financial Industry Regulatory Authority ("FINRA") announced that it had opened its dispute resolution process to investment advisers not registered with FINRA or subject to FINRA jurisdiction.<sup>2</sup> Significantly, to use FINRA's arbitration forum, the investment adviser and investor must reach a *post-dispute* agreement to use the forum and must also agree that they will be subject to FINRA's arbitration rules.

Congress has recently recognized that pre-dispute arbitration clauses may not be in investors' best interests in some contexts. Section 921(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") amended the Investment Advisers Act of 1940 to provide the U. S. Securities and Exchange Commission (the "SEC") with rulemaking authority to prohibit or impose conditions upon the use of mandatory pre-dispute arbitration clauses in investment advisory contracts.<sup>3</sup> In a study of investment advisers and broker-dealers

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<sup>1</sup> "The [FAA]...mandates enforcement of agreements to arbitrate statutory claims. Like any statutory directive, the [FAA's] mandate may be overridden by a contrary congressional command. The burden is on the party opposing arbitration, however, to show that Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue. If Congress did intend to limit or prohibit waiver of a judicial forum for a particular claim, such an intent will be deducible from the statute's text or legislative history...or from an inherent conflict between arbitration and the statute's underlying purposes." McMahon, 482 U.S. at 226-27 (internal citations and quotations omitted).

<sup>2</sup> Bruce Kelly, *FINRA Opens Arb System to RIAs*, Investment News, October 25, 2012, <http://www.investmentnews.com/article/20121025/FREE/121029965>.

<sup>3</sup> The entire text of Section 921(b) of the Dodd-Frank Act is as follows:

(b) AMENDMENT TO INVESTMENT ADVISERS ACT OF 1940.—Section 205 of the Investment Advisers Act of 1940 (15 U.S.C. 80b—5) is amended by adding at the end the following new subsection:

“(f) AUTHORITY TO RESTRICT MANDATORY PRE-DISPUTE ARBITRATION.—The Commission, by rule, may prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of any investment adviser to arbitrate any future dispute between them arising

pursuant to Section 913 of the Dodd-Frank Act, the SEC touched upon mandatory pre-dispute arbitration clauses in investment advisory contracts.<sup>4</sup> The study noted that "...during the Dodd-Frank Act legislative process, concerns were raised regarding mandatory-pre-dispute arbitration, including costs and limited grounds for appeal, among others," but concluded that "...it [did] not recommend that the [SEC] take any action relating arbitration as part of these recommendations, because Section 921 provides the [SEC] the opportunity to review this issue in greater detail."<sup>5</sup>

Given these developments, the Massachusetts Securities Division (the "Division") of the Office of the Secretary of the Commonwealth William Francis Galvin recently conducted a voluntary and anonymous survey of investment advisers registered with and operating in the Commonwealth. Among other things, the purpose of the "Survey Regarding Content of Investment Advisory Contracts" (the "Survey") was to gather information on investment advisers' use of pre-dispute arbitration clauses in their client contracts. The Division mailed the Survey to 710 state-registered investment advisers on Wednesday, January 2, 2013. Responses were requested by Friday, January 18, 2013.

### Findings

The Division has received 370 returned surveys as of February 11, 2013, representing 52.11% of all state-registered investment advisers located in Massachusetts. Of those 370 responses, 87.3% (323) of investment advisers indicated that they use standardized written contracts pertaining to their investment advisory services.<sup>6</sup> Copies of the Survey results for questions pertaining to the use of mandatory pre-dispute arbitration clauses are attached hereto at Exhibit 1.

Of the 323 investment advisory firms that indicated they had written contracts, nearly half confirmed that those contracts contained a mandatory pre-dispute arbitration clause. Of those advisers that have a pre-dispute arbitration clause in their contracts, 62.59% indicated that their clauses designate a specific arbitrator to hear the dispute,<sup>7</sup> and 53.06% (78) of those with clauses confirmed that their clauses designate a specific location or jurisdiction in which the arbitration must take place.<sup>8</sup>

The 92 investment advisory firms whose contracts designate a specific arbitrator identified that arbitrator as follows:

- 65.22% (60) designate the American Arbitration Association ("AAA");
- 16.3% (15) designate FINRA;

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under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors."

<sup>4</sup> The full text of the SEC Study can be found at <http://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

<sup>5</sup> SEC Study, pp. 134-35.

<sup>6</sup> Based on the written explanations provided by a number of respondents, the Division believes that a significant number of the 12.7% (47) of investment advisers who indicated that they did not use standardized written contracts did so because they act only as firms that solicit business for other investment advisory firms and do not provide any other investment advisory services.

<sup>7</sup> Alternatively, 37.41% (55) of investment advisory firms have clauses that do not designate a specific arbitrator.

<sup>8</sup> Similarly, 45.58% (67) of investment advisory firms with arbitration clauses in their contracts explained that their clauses do not specify a required location or jurisdiction for the arbitration.

- 15.22% (14) stated that their contracts designated an arbitrator, but did not specifically identify the arbitrator;
- 1.09% (1) designate FINRA and/or AAA;
- 1.09% (1) designate Endispute; and
- 1.09% (1) designate the Massachusetts Securities Division.

The 78 investment advisory firms whose contracts designate a specific location or jurisdiction in which the arbitration must take place identified the arbitration's location as follows:

- 47.44% (37) stated Massachusetts as the specific location or jurisdiction;
- 24.36% (19) stated Boston, Massachusetts;
- 15.38% (12) confirmed that their arbitration clause designated a location, but did not specifically identify the location;
- 7.69% (6) stated another location in Massachusetts; and
- 5.13% (4) stated other non-Massachusetts locations.

#### Conclusion

As demonstrated by the Division survey, nearly half of investment advisers have pre-dispute mandatory arbitration clauses in their advisory contracts. The SEC has not taken a position on pre-dispute arbitration clauses since the enactment of Dodd-Frank. Meanwhile, FINRA has opened its arbitration forum to investment advisers – a forum that a significant number of advisers have already chosen to designate.<sup>9</sup>

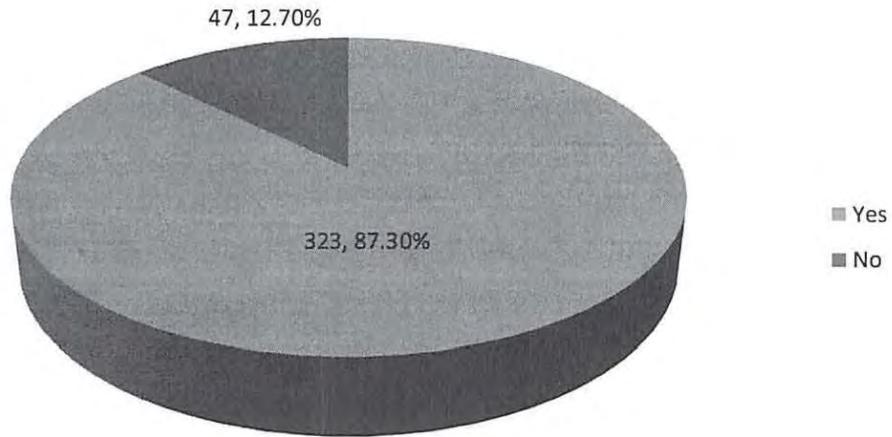
While the Division recognizes that arbitration may be appropriate in selected situations, a clause binding an investor to arbitrate a dispute before its circumstances are established may not be in that client's best interests, nor may such a requirement be consistent with the fiduciary duty owed to the client by the investment adviser. Accordingly, the Division urges that the SEC conduct an in-depth review of the use of these clauses in the advisory context and enact such rules as are necessary and appropriate for the protection of investors.

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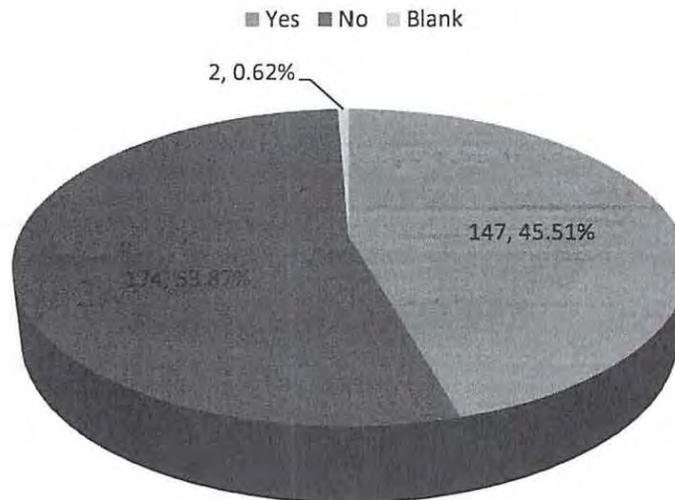
<sup>9</sup> Interestingly, although FINRA requires an agreement between the parties to arbitrate *post-dispute*, a significant number of Massachusetts investment advisers maintain *pre-dispute* arbitration clauses in their contracts designating FINRA as the arbitrator.

Exhibit 1

**Does your investment advisory firm use a standard written contract?**

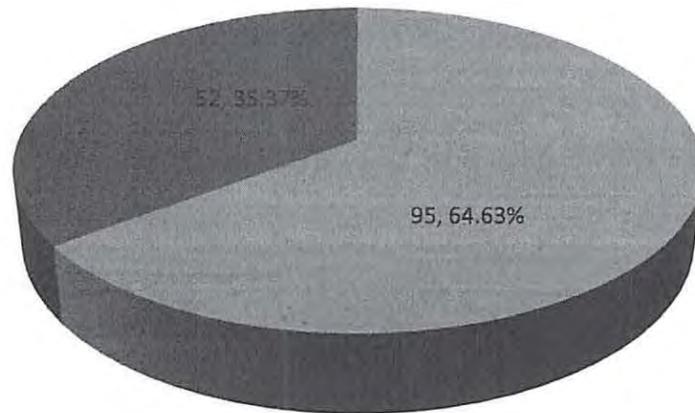


**Does your investment advisory firm's contract contain a mandatory pre-dispute arbitration clause?**

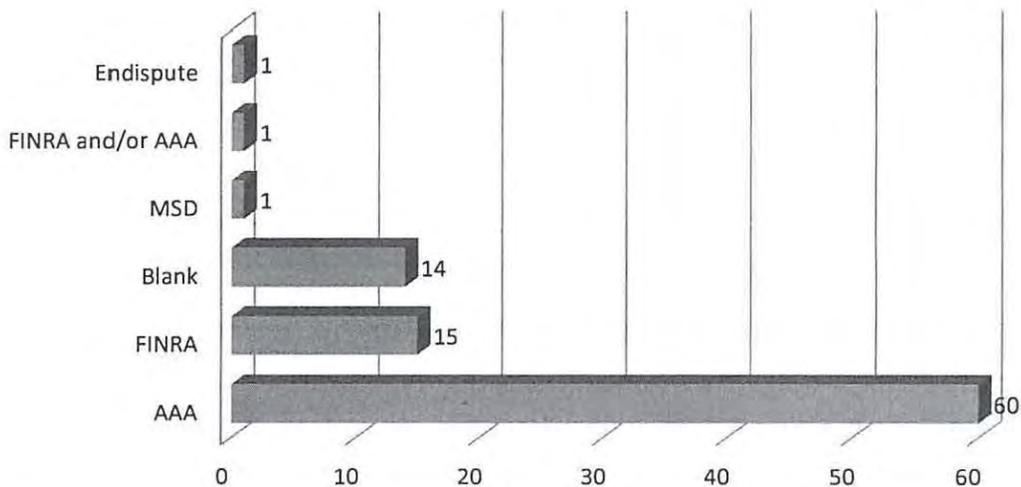


## Does the mandatory pre-dispute arbitration clause designate a particular arbitrator?

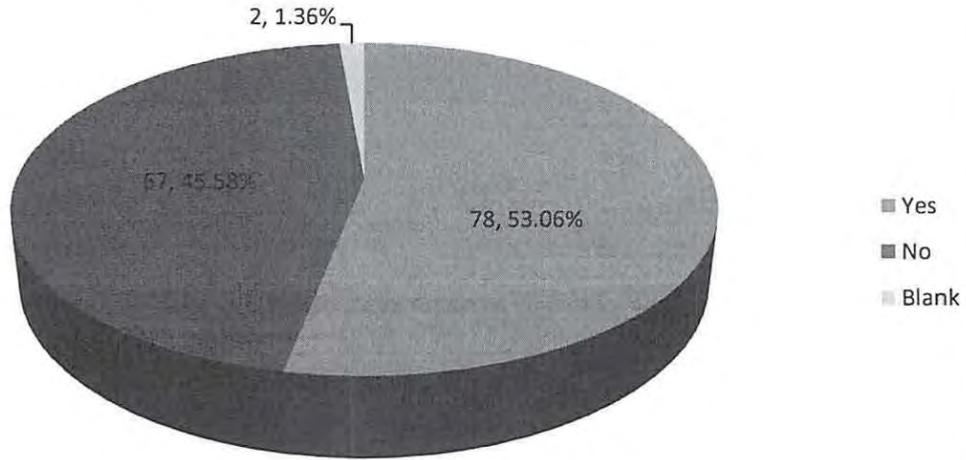
■ Yes ■ No



## Which organization does the mandatory pre-dispute arbitration clause designate as the arbitrator?



**Does the mandatory pre-dispute arbitration clause designate a particular location or jurisdiction for the arbitration?**



**Which location or jurisdiction does the mandatory pre-dispute arbitration clause designate?**

