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OPINION | COMMENTARY

The SEC's Misguided Attack on Shareholder Arbitration

Most securities class actions are meritless, yet federal regulators take action to encourage them.

By Hal Scott

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Johnson & Johnson products **PHOTO:** JOHN RAOUX/ASSOCIATED PRESS

Jay Clayton, chairman of the Securities and Exchange Commission, announced earlier this month that the staff of his agency would allow Johnson & Johnson to block its shareholders from voting on an amendment to its own bylaws. I submitted that amendment as trustee of a trust that owns J&J shares. The proposed amendment would substitute arbitration for costly class-action securities lawsuits. Most securities class actions have no merit, damage shareholder interests, and tarnish the attractiveness of our public capital markets.

The SEC's decision relied entirely on a muddled letter from New Jersey Attorney General Gurbir Grewal, unsolicited by J&J, claiming the bylaw is illegal—though he didn't cite any relevant federal or even New Jersey court precedent. It's a slender reed for the commission to lean on. This was a purely political intervention.

Securities class actions are a unique U.S. invention that continue to make our public equity market uncompetitive with global and private markets. Cornerstone Research estimates that in 2018 8.4% of public companies were subject to such actions. Many foreign companies are for that reason reluctant to list and trade in the U.S., and private companies increasingly remain private. Shareholders should be able to scrap these costly actions by amending their company bylaws to provide instead for arbitration.

Proceeds from initial public offerings in the U.S. market were $46 billion in 2018. That was a relatively good year but more than 20% below the $60 billion historical average from 1996-2006 (without correcting for inflation). The number of publicly listed companies has fallen from more than 7,000 in the late 1990s to below 4,000 today. There are currently about 100 U.S. "unicorns," private startup companies valued at $1 billion or more. Other factors have contributed to these trends. But the threat of securities class actions is unquestionably on the minds of executives contemplating IPOs.

Shareholders don't benefit from these lawsuits. Large asset managers effectively sue themselves—they are both class plaintiffs and shareholders—and plaintiff lawyers take at least 25% on the turn. The average Joe gets so little in settlement that a mere 40% to 60% of shareholders seek to collect their damages. Most claim forms wind up in the wastebasket. Often no real wrongs are committed in the first place, but companies settle to avoid very low probabilities of extremely large damages. Real wrongs will continue to be deterred and uncovered by the news media, whistleblowers, the SEC and the Justice Department. The only real beneficiaries of these suits are—no surprise here—the plaintiff lawyers.

The idea that shareholders could amend their bylaws to bar securities class actions was first proposed in 2006 by the Committee on Capital Markets Regulation, which I direct; the U.S. Chamber of Commerce; and then-New York Mayor Michael Bloomberg and Sen. Chuck Schumer. The principle: Even if the merits of securities class actions are debatable, the right of shareholders to decide if they want them shouldn't be.

In 2012, however, the Obama-era SEC blocked shareholders from making that choice. Gannett and Pfizer , probably worried about getting sideways with the SEC, persuaded the commission to let them exclude arbitration ballot propositions, on the alleged ground that adoption would violate federal securities laws. In 2012 the SEC also blocked Carlyle from putting an arbitration requirement in its limited-partnership agreement when it went public. These SEC actions were taken despite numerous Supreme Court cases holding that under the 1925 Federal Arbitration Act, arbitration is a favored forum for the vindication of rights. The high court has twice held that arbitration provisions don't violate federal securities laws.

What about Mr. Grewal's letter? He relied entirely on a Delaware law (Delaware is the leading corporate jurisdiction in the U.S.) to inform his view of New Jersey law. But Delaware law is itself riddled with confusion. A recent Delaware Supreme Court case supports my position that a bylaw can require shareholders and a company to arbitrate federal securities law claims, but a recent lower court decision (incorrectly) suggests otherwise and will be appealed. In any case, the New Jersey attorney general has no special authority to interpret state corporate law and no expertise in Delaware law. The Federal Arbitration Act, moreover, should pre-empt any state statute or court ruling that prohibits arbitration, a point never mentioned by the SEC. It isn't clear why the SEC thought Mr. Grewal's view of the matter is authoritative.

The SEC's decision is ill-advised, but it presents an opportunity. Since the commission did not block arbitration under federal law, unlike the Obama SEC, any state can now offer companies a refuge by explicitly permitting shareholder arbitration. In the case of the J&J proposal, I have appealed the SEC decision and agree with Commissioner Robert Jackson that the full commission should consider the issue—rather than allowing the staff to continue arbitrarily infringing on shareholder freedom.

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