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Applying the Eligibility Rule in Securities Arbitration: Resolving Circuit Court Conflict regarding the Proper Role of Arbitrators and Courts - Howsam v. Dean Witter Reynolds, Inc.

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Applying the Eligibility Rule in Securities Arbitration: Resolving Circuit Court Conflict Regarding the Proper Role of Arbitrators and Courts

Howsam v. Dean Witter Reynolds, Inc.

I. INTRODUCTION

Client agreements between securities brokers and investors typically contain an arbitration clause. By agreeing to arbitrate disputes arising out of the investment relationship, brokerage customers give up their right to seek redress through the judicial system. Instead, they must arbitrate their claims before one of the securities industry’s self-regulatory organizations. Each self-regulatory organization utilizes a code of procedure to govern its arbitration proceedings. Each code of procedure has an eligibility provision that bars a claim from arbitration unless it is filed within six years of the event or occurrence giving rise to the claim.

The eligibility rule has spawned a great deal of litigation determining whether a court or an arbitrator should determine a claim’s timeliness. As a result, a profound split has occurred among the circuit courts. Some circuits hold that the rule acts as a substantive limitation on the arbitrator’s jurisdiction and therefore, it is the proper role of a court to apply the timeliness provision. Other circuits hold that the rule serves as a statute of limitations and that the arbitrator is to make eligibility determinations. Whether the arbitrator or a court applies the rule is important to both the investor and the securities firm. An investor with a possibly untimely claim would prefer to have the issue resolved by the arbitrator, who, with a more equitable than a strictly legal role, may be convinced to allow equitable arguments that might not be available in court. The brokerage, on the other hand, would desire a court to decide the issue, expecting the time limit to be rigidly enforced.

In Howsam v. Dean Witter Reynolds, Inc., the United States Supreme Court reviewed a Tenth Circuit holding that the eligibility rule presented a question of arbitrability, and was thus for the court to decide. Reversing, the Supreme Court held that the arbitrator, not a court, should apply the time limit rule. The Court’s decision resolves the split among the circuit courts in addition to allowing arbitration clauses in securities firms’ client agreements to serve their purpose of providing an efficient and less costly method of litigating disputes relating to investment accounts, ultimately increasing investor confidence in the securities industry.

II. FACTS AND HOLDING

In 1986, Karen Howsam opened securities accounts with the investment company Dean Witter Reynolds, Inc. (Dean Witter).\(^2\) Dean Witter and its registered representative purchased four limited partnerships for the accounts at an approximate cost of $550,000.\(^3\) The partnerships were represented to Howsam as long-term investments that would increase in value as well as provide income.\(^4\) Through March 1992, the partnerships were listed on monthly account statements at their purchase costs value instead of their current market value.\(^5\) After March 1992, the account statements no longer valued the partnerships at all, but Dean Witter’s registered representative continued to assure Howsam that they were viable investments.\(^6\) In late 1994, Howsam received information from the partnerships indicating that the investments had suffered serious losses in value since their purchase in 1986.\(^7\) Shortly thereafter, Howsam closed her investment accounts with Dean Witter.\(^8\)

In March 1997, Howsam commenced an arbitration proceeding in accordance with a client service agreement she had signed in 1992 (1992 agreement).\(^9\) The 1992 agreement, which Dean Witter drafted:

The Client agrees that all controversies between the Client and Dean Witter . . . concerning or arising from (i) any account maintained with Dean Witter by Client; (ii) any transaction involving Dean Witter and Client . . . or (iii) the construction, performance or breach of this or any other agreement . . . shall be determined by arbitration before any self-regulatory organization or exchange of which Dean Witter is a member. The Client may elect which of these arbitration forums shall hear the matter . . . .\(^10\)

Howsam filed a claim alleging that Dean Witter and its representatives breached their fiduciary duty, and Howsam chose to arbitrate before a three-member arbitration panel of the National Association of Securities Dealers, Inc. (NASD).\(^11\) The breaches included failure to recommend investments which were suited to Howsam’s investment objectives, failure to advise her that the investments were or had become unsuitable for her, and failure to monitor the investments and to keep her apprised of their value so she could make informed decisions with respect to their sale or retention.\(^12\)

\(^2\) Id. at 81.
\(^4\) Id.
\(^5\) Id.
\(^6\) Id.
\(^7\) Id.
\(^8\) Id.
\(^9\) Howsam v. Dean Witter Reynolds, Inc., 261 F.3d 956, 958 (10th Cir. 2001).
\(^10\) Id.
\(^11\) Id.
\(^12\) Id.
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In 1997, in order to commence the arbitration claim before the NASD, Howsam signed a submission agreement (1997 agreement) in which she agreed that the arbitration would be conducted in accordance with the NASD’s Code of Arbitration Procedure (NASD Code). The NASD Code § 10304 provides that “[n]o dispute, claim, or controversy, shall be eligible for submission to arbitration under this Code where six (6) years have elapsed from the occurrence of the event giving rise to act or dispute, claim or controversy.”

In response, Dean Witter filed a complaint in the district court seeking declaratory relief and to enjoin the arbitration from proceeding. Dean Witter contended that the events giving rise to the arbitration claims occurred more than six years prior to the commencement of arbitration, thus making them ineligible for arbitration pursuant to the 1997 agreement and the incorporated eligibility rule in NASD Code § 10304.

Howsam moved to dismiss Dean Witter’s complaint for lack of subject matter jurisdiction, arguing that eligibility was a question for the NASD arbitrator. The district court determined that NASD Code § 10304 “clearly and unmistakably evidences the parties’ intention to have all disputed issues, including those of eligibility of arbitration, arbitrated and not judicially determined.” Holding that the arbitrator, not the court, must determine the eligibility issues presented by Dean Witter’s complaint, the district court granted Howsam’s motion to dismiss, and Dean Witter appealed.

The United States Court of Appeals for the Tenth Circuit recognized “that the circuit courts of appeals are almost evenly divided on the issue of whether the limitations period set forth in NASD Code § 10304 is a substantive eligibility requirement, or jurisdictional prerequisite to arbitration, which must be determined in the first instance by the courts.” In its view, application of NASD Code § 10304 presented a question of the underlying dispute’s arbitrability; and the presumption is that a court, not an arbitrator, will ordinarily decide an arbitrability question. Reversing the district court’s decision, the Tenth Circuit concluded that the district court had erred in finding that the parties “clearly and unmistakably” agreed to allow the arbitrator, rather than the courts, to decide whether specific disputes are arbitrable.

Howsam petitioned the U.S. Supreme Court to review the Tenth Circuit’s decision. The Supreme Court stated that ordinarily the question of whether a dispute should go to arbitration is one for the courts to decide, unless the parties “clearly and unmistakably” agree that it is a question for the arbitrator.

13. Howsam, 537 U.S. at 82.
15. Howsam, 537 U.S. at 82.
16. Id.
17. Howsam, 261 F.3d at 959.
18. Id. at 960.
19. Id.
20. Id. at 970-71.
21. Howsam, 537 U.S. at 82.
22. Howsam, 261 F.3d at 958. See First Options of Chicago, Inc. v. Kaplan, 514 U.S. 938, 944 (1995) (“Courts should not assume that the parties agreed to arbitrate arbitrability unless there is ‘clear[er] and unmistak[able]’ evidence that they did so.” (citations omitted)).
23. Howsam, 537 U.S. at 83.
24. Id. (quoting AT&T Techs., Inc. v. Communications Workers, 475 U.S. 643, 649 (1986)).
Court however, found this presumption to only apply in the "narrow circumstances where contracting parties would likely have expected a court to have decided the gateway matter," not to situations where the parties expect that an arbitrator would make the determination. In these situations, the presumption reverses, and the "gateway" procedural questions are not for the judge, but for an arbitrator to decide. The Court held that, in the absence of any statement to the contrary in the arbitration agreement, it is reasonable to infer that the parties intended the agreement to reflect that understanding. Thus, the Court concluded, the application of the NASD's eligibility or time limit rule, NASD Code § 10304, is a matter presumptively for the arbitrator, not the judge.

III. LEGAL HISTORY

Before opening an account with a securities broker, an investor is typically required to sign a client agreement containing an arbitration clause. By signing the client agreement, the investor agrees to submit any dispute he or she may have with the broker or securities firm to a self-regulatory organization (SRO) forum. In the last two decades, the U.S. Supreme Court has upheld this practice of requiring investors to consent to arbitration of disputes before an SRO.

A. The Federal Arbitration Act and its Application to Securities Arbitration

In 1925, Congress enacted the Federal Arbitration Act (FAA) to end the judicial hostility toward arbitration and to place agreements to arbitrate "upon the same footing as other contracts." Section Two of the FAA provides that written agreements to arbitrate are "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." The FAA advances arbitration by establishing enforceability of arbitration agreements in federal courts. The FAA enables federal courts to stay litigation when the underlying controversy may be resolved by arbitration. It also empowers federal courts to compel arbitration if a party that has previously agreed to arbitrate later refuses. The U.S. Supreme Court has interpreted the FAA as establishing a national policy enforcing private agreements to arbitrate and has stated that any

26. *Id.* at 84 (quoting John Wiley & Sons, Inc. v. Livingston, 376 U.S. 543, 557 (1964)).
27. *Id.* See First Options, 514 U.S. at 944-45.
28. *Howsam*, 537 U.S. at 82-86.
32. *Infra* notes 46-52 and accompanying text.
36. 9 U.S.C. §§ 1-16.

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doubts concerning the arbitrability of an issue should be resolved in favor of arbitration. The Court has also held that the FAA permits the creation of a federal substantive law that is applicable in federal as well as state courts.

Early on, the Supreme Court was not as willing to extend this policy favoring arbitration to cases involving securities arbitration as readily as it had in other situations like labor arbitration. In 1953, the Court first reviewed the interaction of the FAA and securities regulation in *Wilko v. Swan*, and it established a policy of protecting investors from securities brokers. *Wilko* involved a broker who moved to compel arbitration of an investor’s claim in accordance with a preexisting arbitration agreement between the parties. The Court held that despite the agreement to arbitrate, protection of the investor’s rights required judicial review of the claim. This decision in effect invalidated pre-dispute arbitration agreements between investors and securities firms.

In 1974, the Supreme Court began to retreat from the decision in *Wilko* and ultimately overruled it in 1989. In *Scherk v. Alberto-Culver Co.*, the Court held that the FAA required a dispute between two parties to be arbitrated according to a pre-dispute arbitration agreement. In the 1985 case *Dean Witter Reynolds, Inc. v. Byrd*, the Court upheld an arbitration of state claims in order to uphold a policy of enforcing contractual agreements to arbitrate. In the same year, the Court decided *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, which holds that commercial agreements to arbitrate must be enforced according to their terms. In *Shearson/American Express, Inc. v. McMahon*, decided in 1987, the Court placed arbitration on an equal footing with judicial review as a means of resolving securities disputes, noting that nothing in the use of arbitration inherently infringed upon a customer’s substantive rights. Finally, in 1989, the Supreme Court overruled *Wilko* in *Rodriguez de Quijas v. Shearson/American Express, Inc.* In *Rodriguez*, the court abandoned the *Wilko* approach of disfavoring the enforcement of pre-dispute agreements to arbitrate and mandated that courts enforce those agreements for all claims arising under federal securities law.

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42. Wilko, 346 U.S. at 427.
43. Id. at 429.
44. Id. at 437-38.
45. Id.
47. 417 U.S. at 519-20.
49. 473 U.S. at 628.
50. 482 U.S. at 230-32.
51. 490 U.S. at 484.
52. Id. at 484-85.
B. Determining Arbitrability

In *AT&T Technologies v. Communications Workers of America*, the Supreme Court developed the standard for determining whether arbitrators or courts should decide if disputes are arbitrable under pre-dispute arbitration agreement. In *AT&T*, the Court was petitioned to review a lower court order compelling arbitration of an arbitrability issue arising out of a dispute between a union and a company concerning the layoff of employees. The Court held that interpretation of the arbitrability provisions is a function of the courts, reasoning that arbitration is a matter of contract and a party that did not agree to arbitrate disputes cannot be made to arbitrate those disputes. The Court found that "the question of arbitrability . . . is undeniably an issue for judicial determination" and that "unless the parties clearly and unmistakably provide otherwise, the question of whether the parties agreed to arbitrate is to be decided by the court, not the arbitrator." Once it is determined that the parties intended to submit the subject matter of the dispute to arbitration, then the arbitrator, not the Court, determines all "procedural questions which grow out of the dispute and bear on its final disposition." The Court, however, offered no indication of exactly what language would be sufficient to satisfy the "clear and unmistakable" standard. This failure to specify what language is necessary to satisfy the standard led to the Supreme Court's decision in *First Options of Chicago, Inc. v. Kaplan* and ultimately to the circuit split over the NASD's six-year eligibility provision.

In *First Options*, the Supreme Court addressed a situation in which a securities firm sought arbitration of a claim according to an arbitration clause contained in its client agreements. The client, however, had failed to sign the agreement. In its analysis, the Court focused on the underlying question of who should have the power to determine whether the parties agreed to arbitrate. The answer to this question, the Court stated, turns upon what the parties agreed about that matter. After all, "arbitration is simply a matter of contract between the parties." Following its decision in *AT&T*, the Court held that "[c]ourts should not assume

54. *Id.* at 646-47.
55. *Id.* at 648-49; see Mastrobuono v. Shearson Lehman Hutton, Inc., 514 U.S. 52 (1995) (holding that state contract law governs questions of arbitrability according to the contract between the parties).
58. *AT&T*, 475 U.S. at 649. Parties may agree to arbitrate arbitrability only if their agreement offers clear and unmistakable evidence to do so. *Id.*
60. *Id.*
61. *Id.* at 940-41.
62. *Id.* at 941.
63. *Id.* at 943.
64. *Id.*
65. *Id.*; see Mastrobuono v. Shearson Lehman Hutton, Inc., 514 U.S. 52, 62-63 (1995) (holding that the customer agreement must be interpreted in light of three established common law principles of contract interpretation: first, customer agreements and the incorporated NASD Code should be construed as a single writing and therefore should be interpreted as a whole; second, all the documents comprising the single agreement should be considered to be consistent with each other; third, ambiguous language should be construed against the drafting party.)
that the parties agreed to arbitrate arbitrability unless there is ‘clear and unmistakable’ evidence that they did so. In its reasoning the court stated:

In this manner the law treats silence or ambiguity about the question ‘who (primarily) should decide arbitrability’ differently from the way it treats silence or ambiguity about the question ‘whether a particular merits-related dispute is arbitrable because it is within the scope of a valid arbitration agreement’—for in respect to this latter question the law reverses the presumption.

As in AT&T, the Court again failed to specify what language would satisfy the clear and unmistakable standard. The Court reached the conclusion that absent a clear and unmistakable agreement to the contrary, courts, not arbitrators, should resolve the question of arbitrability. Thus, courts should only apply the presumption in favor of arbitration where the issue is whether a dispute is arbitrable because it is within the scope of a valid arbitration agreement— for in respect to this latter question the law reverses the presumption.

In John Wiley & Sons, Inc. v. Livingston, the Supreme Court examined whether courts or arbitrators are the appropriate bodies to determine whether a procedural prerequisite had been satisfied, under which the arbitration agreement conditioned the duty to arbitrate. The procedural prerequisite in question was a timeliness issue; did “the claims relate to a period beyond the limited term of the agreement[?]” In the dispute before the Court, the question could not be answered without considering the merits of the dispute itself. The Court reasoned that “[n]either logic nor considerations of policy [would] compel” that “intertwined issues of ‘substance’ and ‘procedure’ growing out of a single dispute and raising the same questions on the same facts... [should] be carved up between two different forums, one decid[ed] after the other.”

The Court concluded that procedural issues should be left to the arbitrators because the issues are often intertwined with the merits of the dispute, and, if reserved for the courts, could produce duplication of effort and an opportunity for deliberate delay. Thus, in holding that timeliness is an issue for the arbitrator, the Supreme Court established that the court determines “substantive arbitrability”

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67. First Options, 514 U.S. at 944-45.
68. Id. at 944-46.
69. Id. at 944-45.
71. First Options, 514 U.S. at 944-45.
73. Id. at 554.
74. Id. at 557.
75. Id. at 558.
issues while the arbitrator determines "procedural arbitrability" issues.\textsuperscript{76} Once a court determines that the parties are obligated to arbitrate a dispute, "procedural" questions which grow out of the dispute and bear on its final disposition should be left to the arbitrator.\textsuperscript{77} The Court added, "[R]egard[ing] procedural disagreements not as separate disputes but as aspects of the dispute" fits best with the "usual purposes of an arbitration clause."\textsuperscript{78}

C. The Eligibility Rule and the Circuit Court Split

All SROs that sponsor arbitration programs have adopted, with the approval of the Securities and Exchange Commission, the Uniform Code of Arbitration, which was developed to create uniformity in the rules governing arbitration.\textsuperscript{79} Therefore, the procedural rules that govern the arbitration will, for the most part, be the same regardless of the SRO forum selected.\textsuperscript{80} The NASD’s eligibility rule underlying the instant case states that "[a] claim may be submitted for arbitration as long as six years have not elapsed from the date of the occurrence or event giving rise to the claim."\textsuperscript{81} The event giving rise to the claim is typically, but not necessarily, the date of securities purchase.\textsuperscript{82} However, as in the instant case, securities firms did not generally include the current value of the partnership investments in their customer statements, only the original purchase price.\textsuperscript{83} The North American State Securities Administrators ruled that this practice was fraudulent and required brokers to disclose any decrease in the value of the limited partnership from the time it was purchased.\textsuperscript{84} As customers began to discover these investment losses, they submitted claims to SRO arbitral forums.\textsuperscript{85} But, as significant time elapsed between the purchase of the investments and the submission of claims to arbitration, the eligibility rule began to play a much more significant role in the outcome of disputes.\textsuperscript{86}

While the case law appears settled that timeliness issues are to be decided by the arbitrator, a split has arisen in the circuit courts regarding whether the arbitrator or a court should apply the NASD’s eligibility rule.\textsuperscript{87} Five federal circuits have held that the NASD’s eligibility rule and parallel rules of other SRO’s do not "clearly and unmistakably" evidence the parties’ intent as to whom should determine eligibility as required by the Supreme Court in \textit{AT&T Technologies} and \textit{First...
In their analysis, the courts focused on the rule's use of the phrase "eligible for submission to arbitration." The courts reasoned that, because arbitration of a claim is barred if it does not comply with the six-year time limit, the eligibility rule is not a contractual timeliness requirement but a substantive limitation, and thus a question of arbitrability for the courts to apply.

Five circuits have reached the opposite conclusion, holding that the eligibility rule is for the arbitrator to apply. These courts however, have not based their decisions on uniform reasoning. Not relying solely on the "plain language" of the eligibility rule, the Fifth Circuit held that NASD Code § 10304 presents an arbitrability question, but that it is more procedural than substantive and for the arbitrator to decide. The First Circuit held that the eligibility rule is presumed not to be an arbitrability issue for judicial determination unless the parties "clearly and unmistakably" intended to make it one. The Eighth Circuit, in contrast, read the NASD Code as a whole and concluded that a separate provision, § 10324, which provides that "arbitrators shall be empowered to interpret and determine the applicability of all provisions" of the Code, was "clear and unmistakable" evidence of the parties' intent to submit all arbitrability issues to the arbitrator.

The court held that "by adopting the NASD Code . . . as the rules governing their dispute, [the securities firm] agreed to give the arbitrators discretion via [§ 10324] of that Code to interpret [§ 10304's] time limitation."

IV. INSTANT DECISION

The issue before the U.S. Supreme Court in Howsam was whether a court or an NASD arbitrator should apply the NASD Code six-year claim eligibility provision to the underlying controversy. The Court began its analysis by determining whether application of the time limit rule involved a "question of arbitrability," which would make it "an issue for judicial determination unless the parties clearly and unmistakably provide[d] otherwise." The Court acknowledged that a gateway question like the time-limit rule, which would determine whether the underlying controversy would proceed to arbitration on its merits, might be a "question of arbitrability."
It noted however, that by precedent, the phrase "question of arbitrability" has a much narrower scope. The Court has found the phrase applicable only in the limited circumstance where:

[C]ontracting parties would likely have expected a court to have decided the gateway matter, where they are not likely to have thought that they had agreed that an arbitrator would do so, and, consequently, where reference of the gateway dispute to the court avoids the risk of forcing parties to arbitrate a matter that they may well not have agreed to arbitrate.

Thus, any gateway dispute about whether the parties are bound by a given arbitration clause raises a "question of arbitrability" for a court to decide.

However, the Court has found the phrase "question of arbitrability" not applicable in situations where the parties expect that an arbitrator, and not the court, would decide the gateway matter. Under these circumstances, gateway or procedural questions arising from the dispute and impacting the ultimate outcome of the dispute "are presumptively not for the judge, but for an arbitrator, to decide," the Court stated.

The Revised Uniform Arbitration Act (RUAA) provided additional support for the Court. The RUAA provides that arbitrators are responsible for deciding whether a "condition precedent to arbitrability has been fulfilled." The Court looked to the comments to the RUAA which states that:

[I]n the absence of an agreement to the contrary, issues of substantive arbitrability . . . are for a court to decide and issues of procedural arbitrability, i.e., whether prerequisites such as time limits, notice, laches, estoppel, and other conditions precedent to an obligation to arbitrate have been met, are for the arbitrators to decide.

Finally, the Court acknowledged that NASD arbitrators, possessing more expertise about the meaning of their own rule, are comparatively better able to interpret and apply it. The Court reasoned that unless there is a statement to the contrary in the arbitration agreement, it is reasonable to assume that parties intended the agreement to reflect the understanding that NASD arbitrators are in the best position to interpret and apply the arbitration rules of the association. The Court added, "[F]or the law to assume an expectation that aligns (1) decision-maker with (2) comparative expertise will help better to secure a fair and expedi-

99. Id.
100. Id. (citing First Options of Chicago, Inc. v. Kaplan, 514 U.S. 938, 942 (1995)).
101. Id. at 83-84.
102. Id. at 84 (citing First Options, 514 U.S. at 943-46).
103. Id.
104. Id. (emphasis in original).
105. Id. at 84-85 (citing UAA § 6(b), 7 U.L.A. 1 (rev. 2000 Supp. 2002)).
106. Id.
107. Id. at 85 (citing RUAA § 6(c), cmt. 2 (emphasis added)).
108. Id.
109. Id.
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The Court concluded that the “NASD’s time limit rule falls within the class of gateway procedural disputes that do not present what [Supreme Court] cases have called ‘questions of arbitrability.”’ Thus the strong presumption that would submit such questions to the courts does not apply.

Dean Witter argued that “even without an anti-arbitration presumption,” the court should interpret the agreements between the parties as calling for judicial determination of the time limit matter. Focusing on the inclusion of the word “eligible” in the Code’s time limit rule, Dean Witter asserted that the word “indicates the parties’ intent for the time limit rule to be resolved by the court prior to arbitration.” The Court rejected this argument on the presumption that “parties to an arbitration agreement would normally expect the forum-based [arbitrator] to decide forum-specific procedural gateway matters.” Furthermore, the Court reasoned that “any temptation here to place special anti-arbitration weight on the appearance of the word ‘eligible’ in the NASD Code rule is counterbalanced by a different NASD rule” that arbitrators are empowered by the NASD Code to interpret and decide the applicability of the NASD arbitration rules.

Therefore, the Court concluded that without an anti-arbitration presumption and because the NASD’s time limit rule does not fall within the class of gateway procedural disputes regarded as “questions of arbitrability,” it could not conclude that parties intended to have a court, and not the arbitrator, apply the rule. Thus, the Court held that the NASD arbitrator should apply the time limit rule to the underlying dispute.

Concurring only in the judgment, Justice Thomas would also permit the NASD arbitrator to apply the time limit. Reasoning that because the parties included a New York choice-of-law provision in the arbitration agreement, they agreed to be bound by New York law, which permits arbitrators to resolve time limit issues.

V. COMMENT

The Supreme Court’s decision in Howsam is sound. Consistent with the Court’s interpretation of the FAA, the decision promotes the liberal policy favoring arbitration, ensuring the time and cost efficiency afforded by arbitration. The importance of the Howsam decision is twofold. First, the decision resolves the conflict among the circuit courts regarding the question of whether NASD arbitrators or courts apply the NASD’s time limit rule. By deciding that the arbitrators...
are to apply the rule, the Court’s holding will have a far-reaching impact on the arbitration of disputes in the securities industry, injecting uniformity and certainty into the arbitration process, which was non-existent under the circuit split. Second, the outcome offers protection to investors from judicial attacks on the eligibility of their claims for arbitration and on post-arbitration awards, ultimately increasing investor confidence in the securities industry.

The Supreme Court, while holding that NASD Code § 10304 is for the arbitrator to apply, stopped short of deciding a crucial issue present in the instant case. The Court did not determine the extent to which § 10324 provides the “clear and unmistakable” evidence of the parties’ intention to submit questions of arbitrability to the arbitrator. By not deciding the issue, the Court, as in AT&T Technologies, Inc. v. Communications Workers, and First Options of Chicago, Inc. v. Kaplan, again failed to specify what language would satisfy the clear and unmistakable standard.

A. Consistency with Supreme Court’s Interpretation of the FAA

The Court’s decision in Howsam follows Supreme Court precedent of interpreting the FAA as establishing a national policy favoring arbitration. The purpose of this policy in favor of arbitration is to prohibit courts from refusing to enforce valid agreements to arbitrate and to “move the parties out of court and into arbitration as quickly and easily as possible.” The presumption favoring arbitration, however, is only applicable when there is ambiguity as to whether the parties intended the arbitrator or a court to decide an issue. Because NASD Code § 10304, the time-limit rule before the Court, made no indication of whether the arbitrator or a court was to apply it, the national policy favoring arbitration empowers the arbitrator to do so.

The Supreme Court has repeatedly held that one goal of the FAA is to encourage speedy and efficient dispute resolution. It stated, “Contracts to arbitrate are not to be avoided by allowing one party to ignore the contract and resort to the courts. Such a course could lead to prolonged litigation, one of the very risks the parties, by contracting for arbitration, sought to eliminate.”

Allowing courts to decide the timeliness issues would result in such problems. Courts would be required to conduct judicial proceedings often touching upon the merits of the case, in order to determine whether a claim is timely and should thus go to arbitration. The problem with allowing these pre-arbitration judicial proceedings to determine whether claims fall within the six-year period is evident in Hofmann. There, the Third Circuit instructed the trial court at length on what it could and could not do when deciding the timeliness issue. The court stated that the trial court would have to hold a hearing and would have to

123. See supra notes 33-52 and accompanying text.
125. Id. at 24-25.
128. Id. at 1380.
receive extrinsic evidence to decide which claims are arbitrable.\(^{129}\) The court acknowledged that “the district court will be forced to walk a fine line” to adhere to the rule that courts must not decide potential merits of the underlying claims and that “it will be impossible to give full effect to both of these goals . . .”\(^{130}\)

The Supreme Court in *John Wiley\(^{131}\)* recognized this dilemma, as did the Court in the instant case. It is evident that allowing courts to conduct these pre-arbitration “minitrials” to decide under NASD Code § 10304 whether a claim is timely, will result in extra costs and delays, problems the FAA was designed to avoid. By removing the question of timeliness from the courts, the Supreme Court preserves the time and cost efficiency provided by arbitration and in turn promotes the federal policy favoring arbitration.

**B. Resolving the Circuit Court Split**

Before the Supreme Court’s decision in *Howsam*, the circuit split over who was to apply NASD Code § 10304 caused confusion and inconsistency for the securities industry’s arbitration process.\(^{132}\) If parties were located in the jurisdiction of a circuit court which held that courts are to apply the time limit rule, investors might face judicial proceedings to determine the arbitrability of claims before being allowed to engage in the arbitration of those claims. Securities firms had to anticipate where claims would be filed in order to plan their defenses on eligibility grounds, strategies of which largely depended on whether the firms would be defending in an arbitral or judicial forum. This would be particularly problematic for the large securities and brokerage firms that currently dominate the investment landscape considering their presence virtually worldwide. Likewise, location within a particular circuit court jurisdiction would affect the arbitrators themselves in preparing for and conducting the arbitration proceedings. The particular locale would dictate whether they would or would not be allowed to determine the timeliness of claims.\(^{133}\)

With their decision in *Howsam*, the Supreme Court has removed the confusion and uncertainty resulting from the divergent circuit holdings. Now, investors and security firms alike can expect and rely on the fact that an arbitrator and not a court will decide whether claims are eligible under NASD Code § 10304. Investors can be confident that they need only to resort to a single forum to have their disputes heard. Securities firms can approach the defense of these disputes more uniformly, and arbitrators can better prepare for arbitration proceedings.

In his concurring opinion, Justice Thomas stated that he would have focused on the presence of the choice-of-law clause in the arbitration agreement which provided that the agreement be interpreted according to New York state law.\(^{134}\) While the outcome would be the same in the instant case, that the arbitrator would decide the timeliness of Howsam’s claim, Justice Thomas’s approach would make the issue of who is to apply NASD Code § 10304 contingent upon which body of

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129. *Id.*
130. *Id.*
132. See * supra* notes 87-96 and accompanying text.
133. See *id.*
law the choice-of-law provision refers. Not only would this approach fail to alleviate any of the confusion and uncertainty present under the circuit split, it could well result in a great deal more. The possible bodies of law that could be included in an arbitration agreement are vastly more numerable when compared to the comparatively fewer circuit courts. The majority’s approach, while achieving the same result as Justice Thomas’s, does so with the added benefit of increased uniformity and consistency.

C. Investor Protection

Although securities arbitration is touted as a speedy and inexpensive alternative to litigation, brokerage companies can impose expensive and lengthy litigation before the investor ever reaches arbitration. The Supreme Court’s decision protects investors from judicial attacks on the eligibility of their claims for arbitration. Under Howsam, the Court grants the arbitrator the power to apply NASD Code § 10304 in all instances. Securities firms can no longer seek to stay arbitration in a court arguing that a claim is untimely.

There is a general belief that arbitrators will apply the time limit rule less rigidly than courts basing their decisions on what is “‘fair,’ ‘just,’ or ‘sensible’ under the circumstances.” A party with a claim challenged as untimely, would fare better in arbitration than in court, where the arbitrators might apply the time limit rule with more flexibility and allow the running of the time limit to begin upon discovery of the circumstances leading to the claim rather than the original purchase of the investment. Thus, it is of vast importance to the party seeking arbitration of a possibly untimely claim, usually the investor, to know who determines whether the claim is eligible under the time limit rule: a judge or an arbitrator. As a result, brokerage companies often attempt to use the courts in an attempt to have claims declared ineligible. If a court declares the claim untimely, then the investor would not only be prohibited from arbitration but would also be precluded from filing the claim in court. With the Court’s holding in Howsam, investors can avoid the extra cost of litigation and be confident that securities firms will be bound to arbitrate timeliness and that it is an arbitrator who will decide whether a claim is eligible for arbitration.

135. Id.
136. Id. at 86.
137. Perry E. Wallace, Jr., Securities Arbitration After McMahon, Rodriguez, and the New Rules: Can Investors’ Rights Really Be Protected?, 43 VAND. L. REV. 1199, 1248 (1990); see also Quinton F. Seamons, Does Securities Arbitration Go On Forever? Eligibility and Statutes of Limitation, 8 INSIGHTS 17, 19 (May 1994) (stating that arbitrators, aware that an adverse decision would deny the customer’s “day in arbitration,” do not generally address the motions regarding timeliness until the merits of the dispute have been resolved).
140. Supra notes 97-120 and accompanying text.
The *Howsam* decision also protects investors from post-arbitration attacks on arbitrators' awards. Brokerage companies, unable to convince arbitrators to declare claims ineligible, have been successful in persuading courts to vacate arbitration awards on the grounds that the arbitrators exceeded their authority in deciding the timeliness issue.141 In *Howsam*, the Supreme Court granted the necessary authority to arbitrators.142 Arbitrators do not exceed their authority by deciding whether claims comply with the six-year rule. As a result, securities firms will be unable to appeal an arbitrator's award, arguing that the arbitrator did not have the authority to decide NASD Code § 10304 issues.

Although the Supreme Court concluded that arbitrators will not exceed their authority by determining timeliness issues, the Court did not resolve whether it is within an arbitrator's authority to apply equitable arguments to declare a claim timely even though the securities underlying the dispute were purchased more than six years before the filing of the claim. The FAA allows for a court to vacate an arbitration award where arbitrators have “exceeded their powers.”143 However, as long as the arbitrator's award “draws its essence from the . . . agreement,” and the arbitrator is faithful to his/her duties, the award is legitimate and will not be vacated by a court.144

In the instant case, the underlying claim was discovered more than six years following the purchase of the partnership interests underlying the claim.145 If the six-year time limit were strictly applied, Howsam would effectively have lost her claim before she even knew it existed.146 In *Hofmann*, the Court explained that a brokerage company's active concealment of its wrongdoing can be “viewed as an independent cause of action . . . ”147 The NASD’s Director of Arbitration has expressed the position that “the purchase date is not [necessarily] the event or occurrence giving rise to [the] dispute.”148 Thus, considering the significant deference courts give to the decisions of arbitrators, there is little likelihood that an award will be vacated due to an arbitrator allowing the six-year time limit to run upon discovery of the claim rather than the purchase of the underlying securities.

This is especially critical given the recent increase in discovery of claims relating to investments in partnership interests, often purchased many years earlier. Additionally, because securities firms are currently selling other products whose value cannot be determined for many years, persons investing in such vehicles can be assured that they will not lose their claims even before those claims are discoverable.149

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142. *Howsam*, 537 U.S. at 86.
143. FAA § 10(4).
145. *Howsam*, 537 U.S. at 82.
146. Id.
149. Harding, *supra* note 79, at 144.
D. NASD Code § 10324: Clear and Unmistakable Evidence?

In both AT&T Technologies and First Options, the Supreme Court failed to clarify what language would constitute the clear and unmistakable evidence necessary to remove arbitrability questions from the courts and place them in the hands of the arbitrators. In Howsam, the Court again failed to establish such a standard despite the presence of NASD Code § 10324 which states that "[a]rbitrators shall be empowered to interpret and determine the applicability of all provisions under this Code." The Court's only reference to NASD Code § 10324 was as a counter to Dean Witter's assertion that the appearance of the word "eligible" in the NASD Code indicated the parties' intention that a court apply the time limit rule. The Court never answered the question of whether NASD Code § 10324 provided the clear and unmistakable evidence needed to submit the timeliness issue to the arbitrator or what language would satisfy that standard. As a result, the Court in Howsam, as it did in AT&T Technologies and First Options, left the determination to be made by inference from the Court's application of the standard to the specific facts of the each of the cases.

The question of whether NASD Code § 10324 provided the clear and unmistakable evidence necessary to grant arbitrators the power to determine questions of arbitrability was a point of contention for many of the circuit courts deciding NASD Code § 10304 timeliness issues. Four circuits, the Sixth, Seventh, Tenth, and Eleventh, have interpreted NASD Code § 10324 to not be clear and unmistakable evidence of the parties' intention to allow the arbitrator to apply the six-year rule. Two circuits, the Second and Eighth, have reached contrary interpretations, ruling that NASD Code § 10324 does provide the clear and unmistakable evidence necessary to permit the arbitrator to decide arbitrability. By not resolving the question of whether or not NASD Code § 10324 satisfies the clear and unmistakable standard, the Supreme Court leaves the door open for future litigation regarding the impact of NASD Code § 10324 on questions of arbitrability.

VI. CONCLUSION

The Supreme Court's decision in Howsam promotes the longstanding policy in favor of arbitration. The decision ensures the time and cost efficiency afforded
by arbitration. Holding that the arbitrator is to apply the rule, the Court resolves the conflict among the circuit courts regarding the question of whether the arbitrator or a court is to apply the NASD’s time limit rule. In doing so, the decision removes the confusion and uncertainty from the securities arbitration process and increases investor protection. However, by not establishing the clear and unmistakable standard necessary to remove questions of arbitrability from the courts and place them in the hands of arbitrators, the Court again fails to close the door to future litigation.

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