The Uncertain State of FINRA Arbitration

Several recent US Court of Appeals decisions demonstrate that, in certain contexts, members of the Financial Industry Regulatory Authority (FINRA) may seek to avoid arbitration provided for under FINRA Rule 12200 by adding judicial forum selection clauses to their customer agreements. While these decisions agree that parties can contract around FINRA's arbitration requirement, the rulings create a potential conundrum for FINRA members, who may face disciplinary actions by FINRA for expressly avoiding its arbitration mandate.

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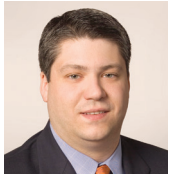

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FINRA is the largest non-governmental regulator of broker-dealer firms doing business in the US and administers nearly all securities-related arbitrations in the US. FINRA has a uniform set of rules for arbitrating disputes between FINRA members and their customers designed to provide fairness, procedural protection and access to remedies that customers otherwise would need to seek in court. Among these rules is FINRA Rule 12200, which requires FINRA members, at a customer's request, to arbitrate disputes that arise in connection with their business activities. FINRA also has rules that call for arbitration of employment disputes between member firms and their employees.

Despite the requirement to arbitrate under Rule 12200, FINRA members may at times seek to contract out of the arbitration obligation by including judicial forum selection clauses in certain agreements with their customers. At least two US Courts of Appeals have held that these clauses are valid and enforceable. An important open issue for FINRA members and their counsel, however, is whether FINRA nonetheless will act to discipline members who try to restrict arbitration rights in their customer agreements.

This article:

- Provides an overview of FINRA's purposes, responsibilities and enforcement powers.
- Examines FINRA Rule 12200 and the circumstances under which FINRA members must submit to arbitration.
- Highlights the key differences between FINRA arbitration and litigation proceedings, including certain benefits and risks associated with each forum.
- Explores the use of forum selection clauses in broker-dealer customer agreements, including the emerging circuit court split over the interpretation of broad, all-inclusive language in these clauses.
- Suggests best practices for counsel to follow pending more specific guidance from FINRA or the courts.

THE ROLE OF FINRA

FINRA was formed in 2007, pursuant to Section 15A of the Securities Exchange Act of 1934 (Exchange Act), through the consolidation of the National Association of Securities Dealers (NASD) and New York Stock Exchange Regulation, Inc., the regulatory arm of the New York Stock Exchange (see *15 U.S.C.A. § 78o-3*). FINRA falls under the regulatory authority of the Securities and Exchange Commission (SEC), but is a private, self-regulatory organization that exercises comprehensive oversight over all securities firms that do business with the public (see *UBS Fin. Servs., Inc. v. W. Va. Univ. Hosps., Inc., 660 F.3d 643, 648 (2d Cir. 2011)*).

FINRA'S PURPOSES AND RESPONSIBILITIES

FINRA's mission is to protect investors by regulating and monitoring securities trading, operations and records, exchange platforms and personnel in the securities industry. To carry out this mission, FINRA:

- Licenses individuals and admits firms to the industry.
- Issues rules to govern member conduct and behavior.
- Examines members for regulatory compliance.
- Disciplines registered representatives and member firms that fail to comply with federal securities law or FINRA rules and regulations.
- Administers the largest forum specifically designed to resolve securities-related disputes between and among investors, securities firms and individual brokers.

An entity must be a FINRA member to participate in a public securities business. By registering as a FINRA member, entities gain the right to participate in the business of brokering and trading securities, but must satisfy certain regulatory requirements and obligations to their customers (*FINRA Bylaws, Art. 4, § 1*). One of those obligations, for example, requires members to arbitrate disputes that arise in connection with their business activities if a customer requests arbitration (see below *FINRA Rule 12200*).

FINRA'S ENFORCEMENT POWERS

Section 15A(b) of the Exchange Act provides FINRA with not only the statutory authority, but also the obligation, to discipline its members for failing to comply with FINRA regulations (*15 U.S.C.A. § 78o-3(b)(7)*). FINRA exercises its enforcement power regularly, including investigating suspected or alleged non-compliance. FINRA's Department of Enforcement may take disciplinary action for violations of:

- FINRA rules.
- Federal securities law, rules and regulations.
- The rules of the Municipal Securities Rulemaking Board.

(See *FINRA Rule 9211*.)

When the Department of Enforcement issues a formal disciplinary complaint, the case is heard before a Hearing Panel, which is chaired by a professional hearing officer and two industry representatives (see *FINRA Rules 9213 and 9231*). Appeals may be heard by FINRA's National Adjudicatory Council (NAC) or Board of Governors (see *FINRA Rule 9311*).

A recent enforcement proceeding against Charles Schwab & Company, Inc. illustrates FINRA's approach to policing compliance with its arbitration rules (see *Box, The Enforcement Action Against Charles Schwab*).

FINRA RULE 12200

In 1973, the NASD adopted the NASD Code of Arbitration Procedure. Section 12 of the NASD Code required that, if desired by a customer, an NASD member was required to submit a dispute to arbitration. This meant that while brokerage firms, pursuant to long-standing case law, could not mandate arbitration through pre-dispute arbitration agreements (PDAAs), customers with claims under federal securities law could compel firms to arbitrate their claims.

In 1987, however, in *Shearson/American Express Inc. v. McMahon*, the US Supreme Court held that PDAAs in securities account contracts are legally binding. The Supreme Court reasoned

The Enforcement Action Against Charles Schwab

In February 2012, FINRA's Department of Enforcement filed a three-cause complaint against Charles Schwab & Company, Inc. for adopting a pre-dispute arbitration provision that included a class action waiver in all of its customer agreements. The waiver foreclosed both judicial class actions and the consolidation of claims in FINRA arbitration, requiring that any customer claim be arbitrated solely on an individual basis.

As to the judicial class action waiver, the Hearing Panel ruled that Schwab violated several FINRA rules related to:

- Limitations on the ability to file claims (*FINRA Rules 2268(d)(1) and (d)(3)*).
- The timing to compel arbitration (*FINRA Rule 12204*).
- Observing high standards of commercial honor (*FINRA Rule 2010*).

Despite these findings, the Hearing Panel determined that it could not enforce the FINRA rules at issue because they were preempted by the Federal Arbitration Act's (FAA's) presumption in favor of arbitration. The Hearing Panel concluded that there is no clear expression of congressional intent to preserve judicial class actions as an option for customer claims when there is an agreement providing for arbitration of those claims. (See *Dep't of Enforcement v. Charles Schwab & Co., 2014 WL 1665738, at *3-4 (Apr. 24, 2104)*.)

However, on April 24, 2014, on appeal by the Department of Enforcement and cross-appeal by Schwab, FINRA's Board of Governors reversed the Hearing Panel's determination on the judicial class action waiver. Among other things, the Board found a "congressional command" that permitted FINRA to enforce its rules and was sufficient to override the usual presumption in favor of arbitration. (*Schwab & Co., 2014 WL 1665738, at *13-16*.)

Notably, the Board distinguished this case, which involved customer agreements, from those involving class action waivers in agreements between FINRA member firms and their employees (see *Box, FINRA Arbitration Rules in the Employment Context*), which Schwab argued should direct the outcome in this case (*Schwab & Co., 2014 WL 1665738, at *8*).

As to the class arbitration waiver, the Hearing Panel determined that Schwab's attempt to prevent FINRA arbitrators from consolidating more than one party's claims violated FINRA Rule 12312(b), which provides arbitrators with the authority to consolidate the claims of multiple parties. The Hearing Panel determined that the FAA did not preclude enforcement of this rule and fined Schwab $500,000 for the violation. On appeal, the Board upheld the Hearing Panel's determination, holding that Schwab's waiver "squarely contradicts FINRA's well-established arbitration procedure for consolidation of arbitration claims," and that Schwab could not modify the SEC-approved FINRA arbitration rules by agreement with its customers. (*Schwab & Co., 2014 WL 1665738, at *21-22*.)

that by agreeing to arbitrate a statutory claim, "a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum." (*482 U.S. 220, 229-230, 238 (1987)* (citation omitted).) Following this decision, most brokerage firms began to use PDAAs in their customer agreements and arbitration became the primary means for resolving securities disputes.

FINRA Rule 12200, the current version of NASD Code Section 12, requires FINRA members to submit to arbitration if all of the following are met:

- Arbitration is either required by a written agreement or requested by the customer.
- The dispute is between a customer and a member or an associated person of a member.
- The dispute arises in connection with the business activities of the member or associated person, with certain exceptions for insurance company members.

Therefore, FINRA Rule 12200 gives customers the unilateral right to demand arbitration even in the absence of a PDAA.

Courts uniformly hold that, for purposes of the Federal Arbitration Act (FAA), FINRA Rule 12200 creates an enforceable "agreement in writing" (see, for example, *Goldman, Sachs & Co. v. City of Reno, 747 F.3d 733, 739 (9th Cir. 2014)*; *Waterford Inv. Servs., Inc. v. Bosco, 682 F.3d 348, 353 (4th Cir. 2012)*). Moreover, where there is any question about the scope, as opposed to the existence, of an arbitration clause, the FAA's presumption of arbitrability applies (see, for example, *Goldman, Sachs & Co. v. Golden Empire Sch. Fin. Auth., 764 F.3d 210, 215 (2d Cir. 2014)*).

Search Understanding the Federal Arbitration Act and Compelling Arbitration in US Federal Courts for more on the FAA and the presumption favoring arbitration.

FINRA ARBITRATION VERSUS LITIGATION

Although FINRA members historically have included PDAAs in their customer agreements and are otherwise subject to FINRA Rule 12200, in some circumstances, they may nonetheless prefer to litigate, rather than arbitrate, certain claims. This preference might be at odds with the forum the customer might favor.

There are several differences between FINRA arbitration and litigation that might influence this decision, such as:

- **More limited discovery.** FINRA rules offer less expansive discovery than the broad discovery rules that govern in state or federal courts (see *FINRA Rules 12505-12511*). Discovery in FINRA arbitration is generally limited to document production, with depositions being strongly discouraged. As a result, evidence that might bolster a defense (or a claim) may not be found. In contrast, broad discovery is presumptively proper in judicial proceedings and may uncover vast amounts of information that discovery in arbitration may not reach.
- **Restrictions on dispositive motions.** FINRA rules preclude dispositive motions prior to a hearing, except in extremely limited procedural circumstances (see *FINRA Rule 12504(a)*). This may give a claimant sufficient leverage to settle a weak claim that a court might simply dismiss early in the proceedings.
- **Limited judicial review of awards.** Judicial review of FINRA awards, as with all arbitration awards, is extraordinarily narrow and deferential (see, for example, *STMicroelectronics, N.V. v. Credit Suisse Sec. (USA) LLC, 648 F.3d 68, 78 (2d Cir. 2011)* (stating that the court "will not vacate an award because of a simple error in law or a failure by the arbitrators to understand or apply it but only when a party clearly demonstrates that the panel intentionally defied the law") (internal quotations and citation omitted)). This may be a particularly important factor in large, complex transactions, because a losing party in litigation has a chance, not available in arbitration, to nullify a decision based on errors of fact, law or procedure.
- **No requirement to explain award rationale.** FINRA arbitrators are not required to give written reasons for their awards, unless all of the parties jointly request an explained decision (see *FINRA Rule 12904(f),(g)*).
- **Arbitrators with subject matter expertise.** Arbitrators in FINRA arbitration proceedings are often securities law experts with an understanding of the industry and, therefore, may be less susceptible to customers' arguments than a judge or jury.
- **Greater leeway to recognize claims.** FINRA arbitrators are not strictly bound by the law and may recognize substantive claims, including breaches of FINRA regulations, that may not constitute valid causes of action in court.

Additionally, arbitration is generally believed to be faster and less expensive than litigation, particularly where discovery is limited and the proceedings are accelerated. Arbitration also provides an opportunity to resolve disputes privately, often subject to confidentiality restrictions, which may be attractive to parties who prefer to avoid media attention or other disclosure.

Search Why Arbitrate? for more on the pros and cons of arbitration versus litigation.

Search How to Choose a FINRA Arbitration Panel Checklist for guidance on selecting the most suitable arbitrators for disputes heard before FINRA.

FORUM SELECTION CLAUSES IN CUSTOMER AGREEMENTS

Where a FINRA member would prefer to resolve disputes with certain customers in a judicial forum (for example, in a large, complex transaction) it may decide to include a judicial forum selection clause in those customer agreements. These provisions are intended to supersede or waive the right to arbitration under FINRA Rule 12200. FINRA members, however, must weigh the benefit of seeking to enforce a forum selection clause against the risk of facing disciplinary action by FINRA for violating its rules. Further, a recent circuit court split over the interpretation of broad, all-inclusive forum selection clauses adds an additional layer of difficulty to this decision.

RISK OF FINRA DISCIPLINARY ACTION

As the *Schwab* decision illustrates (see *Box, The Enforcement Action Against Charles Schwab*), FINRA generally takes the position that contract provisions at variance with its rules may, at a minimum, conflict with the rule requiring members to conduct their businesses consistent with a "high standard of commercial honor and just and equitable principles of trade" (*FINRA Rule 2010*). Indeed, in the context of Rule 12200, FINRA's interpretive guidance cautions that:

> "It may be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 2010 for a member or a person associated with a member to ... fail to submit a dispute for arbitration under the Code as required by the Code ...."

(*FINRA IM-12000*.)

As a result, a FINRA member's preference to "have its day in court" could potentially trigger regulatory enforcement proceedings and disciplinary action.

EMERGING CIRCUIT COURT SPLIT

Recent rulings in the US Courts of Appeals for the Second, Fourth and Ninth Circuits may help FINRA members seeking to enforce a forum selection clause. These cases, however, illustrate the somewhat conflicting judicial approach to the circumstances under which a forum selection clause can supersede FINRA-mandated arbitration. (See *Golden Empire, 764 F.3d 210*; *UBS Fin. Servs, Inc. v. Carilion Clinic, 706 F.3d 319 (4th Cir. 2013)*; *City of Reno, 747 F.3d 733*.)

These cases presented similar underlying facts. In connection with the issuance of auction rate securities, FINRA member broker-dealers were retained to advise on the transactions and serve as underwriters. Although the precise contract terms differed, each agreement contained a forum selection clause, which provided that disputes would be resolved in federal court. The clause at issue in *Goldman Sachs & Co. v. Golden Empire Schools Financing Authority* is typical of those in all three cases. It stated:

> "The parties agree that all actions and proceedings arising out of this Broker-Dealer Agreement or any of the transactions contemplated hereby shall be

FINRA Arbitration Rules in the Employment Context

An appeal pending before the Second Circuit will address the extent to which parties may contract around the FINRA arbitration rules, in this case, where financial advisor employees sought a judicial forum and the financial institution employer moved to compel arbitration.

Cohen v. UBS Financial Services, Inc. involves an arbitration clause included in compensation plans and other employment agreements, in which employees agreed to individually arbitrate claims arising under the Fair Labor Standards Act (FLSA) or any other federal, state or local employment laws. Certain employees later asserted class and collective action claims against UBS for alleged violations of the FLSA, the California Labor Code and the California Unfair Competition Law, and UBS moved to compel arbitration based on the agreements. The employees argued that the arbitration agreements at issue were unenforceable because they violated FINRA Rule 13204, which prohibits arbitration of class or collective claims. (*No. 12-2147, 2012 WL 6041634, at *1-2 (S.D.N.Y. Dec. 4, 2012)*.)

Nonetheless, the US District Court for the Southern District of New York granted UBS's motion to compel arbitration. The court stated that while FINRA Rule 13204 appears to prohibit arbitration of class or collective claims, the rule also expressly states that it does not "otherwise affect the enforceability of any rights under the [FINRA Code of Arbitration Procedure for Industry Disputes] or any other agreement." As a result, parties may choose to enter into additional agreements beyond the scope of the FINRA arbitration rules, and those agreements may be enforceable. (*Cohen, 2012 WL 6041634, at *3*.)

The *Cohen* decision is currently on appeal to the Second Circuit. On October 1, 2014, the Securities Industry and Financial Markets Association (SIFMA), an industry trade group representing securities firms, banks and asset management companies, filed an amicus brief in support of the district court's decision. SIFMA argued that affirming the decision would:

- Be consistent with strong federal policy favoring arbitration.
- Lead to greater predictability and respect for contractual commitments.
- Allow for employment disputes to be resolved promptly and cost-effectively.

SIFMA further argued that all of these things would "inure to the benefit of all industry participants" and that the "ability to use and enforce class action waivers in employment arbitration agreements is necessary to prevent abusive and manipulative litigation tactics from being used to oust [FINRA] of its proper jurisdiction." (*Brief of the Securities Industry and Financial Markets Ass'n as Amicus Curiae in Support of Defendants-Appellees and Affirmance, at 10-11, Cohen v. UBS Financial Services, Inc., No. 14-0781 (2d Cir. Oct. 1, 2014)*.)

Search Class Arbitration Waiver (US) for a model clause expressly prohibiting class arbitration or the consolidation of claims, with explanatory notes and drafting tips.

> brought in the United States District Court in the County of New York and that, in connection with any such action or proceeding, submit to the jurisdiction of, and venue in, such court."

(*764 F.3d at 212*.)

In 2008, the market for auction rate securities collapsed, allegedly leading to losses for the customers. In each case, the customers initiated arbitration before FINRA. The broker-dealers, relying on the forum selection clauses in their respective agreements, initiated actions in court to enjoin arbitration.

Fourth Circuit

In *UBS Financial Services, Inc. v. Carilion Clinic*, the Fourth Circuit noted that the otherwise binding obligation to arbitrate disputes under the FINRA rules may be superseded or displaced by a specific agreement between the parties. The question therefore was whether the relevant forum selection clause was specific enough to displace FINRA arbitration, which the court called a straightforward issue of contract interpretation. The Fourth Circuit found that the forum selection clause in this case was not sufficiently specific because, among other things, it did not:

- Contain any reference to arbitration.
- Specifically indicate that a customer's preexisting right to FINRA arbitration would be superseded by its terms.

The court also rejected UBS's argument that the phrase "action or proceeding" in the forum selection clause included arbitration, and found that the forum selection clause did not supersede, displace or waive the arbitration otherwise provided by FINRA Rule 12200. (*706 F.3d at 328-30*.)

Second and Ninth Circuits

In contrast, both the Second and Ninth Circuits have held that the forum selection clauses at issue superseded Rule 12200 and

precluded the customers from maintaining a FINRA arbitration proceeding on their claims.

In *Golden Empire*, the Second Circuit first noted that, although the FAA creates a presumption of arbitrability, that presumption applies to disputes over the scope of an arbitration clause, not to disputes concerning the existence of an arbitration agreement. The court assumed (and the broker-dealers did not dispute) that FINRA Rule 12200 constitutes a preexisting written agreement between FINRA and its members to submit to arbitration and that the forum selection clause was a later-executed agreement.

Because it was undisputed that a prior agreement to arbitrate existed, the court found that the FAA's presumption did not apply. Pointing to the "all-inclusive and mandatory" nature of the forum selection clause, the court found that the clause displaced the agreement to arbitrate and required litigation of the dispute in court. The Second Circuit specifically rejected the Fourth Circuit's holding that "all actions and proceedings" excludes arbitration, based on the "general understanding" of those terms. (*Golden Empire, 764 F.3d at 214-17.*)

Similarly in *Goldman Sachs & Co. v. City of Reno*, the Ninth Circuit held that the forum selection clause at issue barred arbitration. Like the Second Circuit, the Ninth Circuit did not apply the presumption in favor of arbitration because the forum selection clause casts doubt on whether an agreement to arbitrate remained in effect at all. Applying state law contract interpretation principles, the court held that the all-inclusive and mandatory nature of the forum selection clause superseded the default obligation to arbitrate, and that by agreeing to that clause, the customer disclaimed any right it might otherwise have had to FINRA arbitration. (*747 F.3d at 741-46.*)

In August 2014, the City of Reno filed a writ of *certiorari* with the US Supreme Court for review of the Ninth Circuit decision, arguing that the court should have applied a presumption in favor of arbitration pursuant to the FAA. On November 10, 2014, the Supreme Court denied the City of Reno's petition without explanation (*City of Reno v. Goldman, Sachs & Co., 135 S.Ct. 477 (2014)*).

Search Ninth Circuit: Forum Selection Clause Supersedes Right to FINRA Arbitration for more on the Second and Ninth Circuit decisions.

BEST PRACTICES FOR COUNSEL

As in all cases where the law is unsettled, broker-dealers cannot be certain that forum selection clauses that waive a customer's preexisting right to FINRA arbitration will be enforceable. Moreover, even if the proper language is used in an agreement, issues remain concerning whether an arbitration waiver, although fully enforceable as a matter of law, exposes a FINRA member to discipline if FINRA takes the position that such a provision violates FINRA Rule 12200. If, however, a FINRA member prefers to resolve disputes in a judicial forum, counsel should:

- **Use specific language in the agreement.** The broker-dealer customer agreement should be specific and expressly state that the customer is making a knowing waiver of its right to arbitrate future claims. It also may be helpful to recite any consideration that a customer bargained for in exchange for its agreement to waive its right to arbitration.
- **Limit any arbitration waivers to agreements between sophisticated parties.** One of the themes in the *Schwab* decision was a concern to protect the rights and remedies of retail customers. This is consistent with FINRA's well-known commitment to consumer protection. Although the FINRA rules do not make a distinction between corporate entities and consumers, the *Schwab* decision suggests that the terms of a standardized customer contract will receive stricter scrutiny than those in a negotiated contract with a sophisticated counterparty.
- **Explain the risks of seeking an arbitration waiver.** As discussed above, it is possible that an arbitration waiver in a customer context may result in a FINRA disciplinary referral. On the other hand, a FINRA member can choose not to enforce an arbitration waiver where a customer seeks arbitration. Counsel should discuss these possibilities with the broker-dealer at the beginning of a transaction rather than after a dispute arises.
- **Support discussions with FINRA staff members to ascertain FINRA's position and intended course on the issue.** Counsel may consider requesting that FINRA issue guidance or at least opine on whether it might seek to discipline a FINRA member that follows these controlling judicial rulings.