FINRA Hearing Panel Upholds Class-Action Waiver in View of FAA and Supreme Court Precedent But Not Consolidation Waiver

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A flurry of news articles hit the wires over the past week announcing the long-anticipated FINRA Hearing Panel decision against Charles Schwab & Company, Inc. regarding its inclusion of a class-action waiver and consolidation waiver in its customer agreements. *Dept. of Enforcement v. Charles Schwab & Company, Inc.*, Disciplinary Proceeding No. 2011029760201 (FINRA OHO Feb. 21, 2013) (the "Decision"). The Hearing Panel's 48-page decision extends the reach of the Federal Arbitration Act ("FAA") and U.S. Supreme Court precedent, reminding the securities industry that FINRA Rules, even when supported by explicit regulatory support, cannot supplant federal statutory mandate and congressional intent. In this case, the federal statutory mandate allows parties to privately agree that an investor cannot pursue a class action in court in the event a dispute arises. Investors must pursue their claims in arbitration. Parties may not, however, contract around FINRA's dominion over its own forum, in this case specifically with regard to an arbitrator's power to consolidate actions.

FINRA's Department of Enforcement filed its complaint against Schwab on February 1, 2012, alleging that Schwab violated FINRA rules by including two provisions in its customer account agreements (1) a class-action waiver that waived the right to bring a class action or any type of representative action against Schwab or any related third party in court, thus requiring all customer claims to go to arbitration, and (2) a consolidation waiver that disallowed arbitrators from consolidating more than one party's arbitration claims. In May 2012, the parties briefed and argued motions for summary disposition, contending each was entitled to summary disposition as a matter of law.

The Panel ruled in Schwab's favor on the permissibility of the class-action waiver but ruled against Schwab's attempt to disallow arbitrators from consolidating arbitrations. With regard to both provisions, the Panel acknowledged that FINRA Rule 2268 prohibits FINRA member-firms from utilizing pre-dispute arbitration agreements that limit or contradict the rules of any self-regulatory organization ("SRO"). *See* FINRA Rule 2268(d)(1). Rule 2268(d)(1) and specific rules with regard to class actions and consolidation formed the basis of the Hearing Panel's decision that Schwab violated FINRA Rules by including class-action and consolidation waivers. The Hearing Panel determined that the FAA, Supreme Court precedent, and the lack of congressional intent exempting FINRA arbitrations from the FAA overrode FINRA's ability to sanction Schwab for its class-action waiver, but not its consolidation waiver.

FINRA and Class-Action Waivers

FINRA Rules prohibit member-firms from utilizing pre-dispute arbitration agreements that limit or

contradict the rules of any SRO. FINRA Rule 2268(d)(1). FINRA Rule 2268(d)(3) also disallows limiting the ability of a party to file a claim in court "permitted to be filed in court under the rules of the [applicable] forums." *Id.* at (d)(3). In addition, FINRA Rules specifically preclude class actions from being brought in FINRA arbitration and contemplate such claims proceeding in court. A claimant cannot attempt to arbitrate a dispute while a class action encompassing that claim goes forward, unless the claimant stipulates that he or she will not participate in any class action recovery. FINRA Rule 12204(b). FINRA Rules also prevent member-firms from enforcing an arbitration agreement for a claim subject to a class action unless (i) class certification is denied, (ii) the class is decertified, (iii) the class member is excluded from the class, or (iv) the class member withdraws from the class. *Id.* at (d). In addition, the SRO and the SEC have both affirmed their support for investors' abilities to pursue their class claims in court, as opposed to arbitration. Decision at 13-14.

Notwithstanding FINRA rules and the regulators' support in favor of investor class actions proceeding in court, the Hearing Panel concluded that the FAA and Supreme Court precedent compelled it to conclude that the FAA barred the enforcement of FINRA's Rules requiring broker-dealers to allow customers to pursue judicial class actions where the parties agreed to pre-dispute agreements to resolve disputes in arbitration. *Id.* at 9. The Hearing Panel acknowledged that, in *AT&T Mobility v. Concepcion*, the U.S. Supreme Court held that class actions are not exempt from the general rule that allowing a party who agreed to be bound to an arbitration agreement to pursue a claim in court represents "hostility" to arbitration that is inappropriate and unenforceable. Decision at 9. Moreover, decades prior to the Court's decision in *Concepcion*, the Supreme Court ruled that securities law claims are no exception to the FAA's mandate that a party to an arbitration agreement must resolve any claim subject to that agreement in arbitration. *Id.* Based on the FAA and Supreme Court precedent, the Panel concluded that absent a clear expression of congressional intent to carve out an exception to the FAA, it could not override the FAA's mandate. The Panel, thus, upheld Schwab's class-action waiver:

> Neither you nor Schwab will be entitled to arbitrate any claims as a class action or representative action . . . .
> You and Schwab agree that any actions between us and/or Related Third Parties shall be brought solely in our individual capacities. You and Schwab hereby waive any right to bring a class action, or any type of representative action against each other or any Related Third Parties in court. You and Schwab waive any right to participate as a class member, or in any other capacity, in any class action or representative action brought by any other person, entity, or agency against Schwab or you.

Id. at 19. The Panel's holding regarding this acceptable language serves as a guide to other broker-dealers desiring to include a class-action waiver in their customer agreements.

Restricting the Ability to Consolidate Claims

The Hearing Panel also held that Schwab violated FINRA rules by including a provision in its customer agreements stating, "[A]rbitrator(s) shall have no authority to consolidate more than one parties' [sic] claims." Neither the FAA nor Supreme Court precedent affected FINRA's ability to sanction Schwab's inclusion of that waiver in its customer agreements.

In addition to Rule 2268(d)(1), which prohibits member-firms from limiting or contradicting the rules of any SRO, as stated above, FINRA Rule 12312 governs procedures for joining the claims of multiple parties and grants arbitrators the power to join claims. FINRA Rule 2268(d)(1), 12312. The Hearing Panel held that the FAA did not bar FINRA from enforcing its rules regarding joinder and

consolidation. Decision at 43. In fact, the Panel found that consolidation – in contrast to class action procedure – to be consistent with the goals of the FAA because consolidation promotes efficiency and streamlined resolution of similar issues. *Id.*

The Hearing Panel held that Schwab should be fined for including the consolidation waiver and directed Schwab to take corrective action, including notifying customers who received the consolidation wavier of its unenforceability.

Actions To Be Taken by Other Broker-Dealers

FINRA has appealed the Hearing Panel's decision. If it is affirmed, broker-dealers should review their customer agreements and determine whether to add a class-action waiver. In the meantime, broker-dealers should confirm that their agreements do not contain provisions that limit or contradict the rules of any SRO.