Arbitration

FINRA's Arbitration Agreement: Second Class Status?

BY ADAM WEINSTEIN AND BETTE SHIFMAN

A trend of court decisions has created a dichotomy in the interpretation of the arbitration agreement imbedded in the code of the Financial Industry Regulatory Authority (FINRA) and all other arbitration agreements. Given the complexity of the securities industry and the many devices that can be employed by firms and brokers vis-à-vis investors, FINRA gives customers an express choice of arbitrating claims against brokerage firms without the need for a direct contractual arbitration agreement between the parties. This is accomplished by the brokerage firm's FINRA membership agreement, whereby all broker-dealers are required to comply with FINRA's Rules, including a requirement to participate in a FINRA arbitration initiated at a customer's request.

In two separate areas, courts have begun to chip away at the protections afforded to investors by FINRA. One area is the continual shrinking of the definition of a "customer," and the other is the interpretation of forum selection clauses so as to deny investors access to FINRA arbitration.

FINRA ARBITRATION

FINRA operates the largest arbitration dispute resolution forum in the securities industry. FINRA's arbitration forum is used to resolve disputes between and among investors, brokerage firms, and individual brokers. FINRA was created in 2007 with the merger of the NASD and NYSE. The FINRA Rules incorporate its predecessor's rules and codes of conduct, and judicial decisions have extended to the FINRA Rules application of cases interpreting similar predecessor provisions.

FINRA's arbitration provision is contained in FINRA Rule 12200 (bit.ly/finra12200), requiring a member to arbitrate a dispute if: 1) the arbitration is requested by a customer; 2) the dispute is between a customer and a member or associated person; 3) it is in connection with the business activities of the member or associated person; and 4) the dispute does not involve insurance business activities. A "customer" is defined under the FINRA Code simply as "not a broker or a dealer."

PRESUMPTION OF ARBITRABILITY

Under the Federal Arbitration Act (FAA), "courts must place arbitration agreements on an equal footing with other contracts . . . and enforce them according to their terms" (see *AT&T Mobility LLC v. Concepcion,* 131 S. Ct. 1740 (2011; bit.ly/att-concepcion2010)). The analysis typically involves two steps. First, a valid agreement to arbitrate must exist, and second, the specific dispute must fall within the substantive scope of that agreement. However, once a court concludes that "the contract contains an arbitration clause," the U.S. Supreme Court has explained that "there is a presumption of arbitrability" and arbitration can only be denied if "it may be said with positive assurance that the arbitration clause is not susceptible of an interpretation that covers the asserted dispute" (see *AT&T Techs., Inc. v. Commc'ns Workers of Am.,* 475 U.S. 643 (1986; bit.ly/atttech-comm1986). In determining the second prong of the analysis, any "[d]oubts should be resolved in favor of coverage," especially when "the [arbitration] clause is as broad…" The Supreme Court has also made clear that "doubts" include "the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability" (see *Zandford v. Prudential-Bache Sec., Inc.,* 112 F.3d 723 (4th Cir. 1997; bit.ly/zandford-prubache1997), *quoting Moses H. Cone Mem. Hosp. v Mercury Const. Corp.,* 460 US 1, 24-25 (1983; bit.ly/mosescone1983)). The Supreme Court's arbitration analysis has remained the same over the last thirty years and is adhered to in non-FINRA arbitration disputes.

JUDICIAL INTERPRETATION OF FINRA ARBITRATION RULE

Until approximately ten to fifteen years ago, courts routinely applied the same analysis to FINRA (and its predecessors') arbitration. Under the Supreme Court's arbitration analysis, courts routinely found that, even in the absence of privity and an express contractual arbitration clause, the FINRA rule constituted an agreement in writing, triggering a presumption in favor of arbitration, and subjecting any dispute concerning the scope of the arbitration clause, including in this case FINRA's arbitration rule, to the federal policy favoring arbitration. Citing authority that "well-established common law principles dictate that in an appropriate case a nonsignatory can enforce, or be bound by, an arbitration provision within a contract executed by other parties," the court in *Washington Square Sec., Inc. v. Aune*, 385 F.3d 432 (4th Cir. 2004; bit.ly/washsq-aune2004) held that "[t]he NASD Code constitutes an 'agreement in writing' under the Federal Arbitration Act (see also *Spear, Leeds & Kellogg v. Cent. Life Assur. Co.,* 85 F.3d 21, 26 (2d Cir. 1996; bit.ly/spearleedskell1996): "the arbitration rules of a securities exchange are themselves 'contractual in nature,'" *quoting Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Georgiadis,* 903 F.2d 109, 113 (2d Cir. 1990; bit.ly/merrlynch-georgiadis1990) and *Bensadoun*

(continued on next page)

Adam Weinstein is a partner at Gana LLP (www.ganalawfirm.com), whose practice focuses on all aspects of securities and commercial litigation. He has successfully represented hundreds of investors, business owners, and companies in litigation brought through arbitration, state, and federal courts.

Bette Shifman is Vice President, Director of Publications, and Special Counsel at CPR Institute, where her duties include editorial responsibility for *Alternatives*. Any views expressed in this article are her own.

Arbitration

(continued from previous page)

v. Jobe-Riat, 316 F.3d 171 (2d Cir. 2003; bit.ly/bensadoun2003): "interpretation of the NASD arbitration provision is a matter of contract interpretation…[t]he analysis differs from ordinary contract interpretation in that any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration.")

Courts have recognized that investors were the intended third-party beneficiaries entitled to invoke the FINRA arbitration provision. In *Spear, Leeds* (bit.ly/spearleedskell1996), for example, the court found that "decisional law recognizes that the FAA requires the enforcement of an arbitration agreement not just in favor of parties to the agreement, but also in favor of third party beneficiaries of the members' agreement to abide by the [New York Stock] Exchange's Constitution and Rules when they join." In *Kidder, Peabody & Co. v. Zinsmeyer Trusts P'ship,* 41 F.3d 861 (2d Cir. 1994; bit.ly/kidder-zins1994) a customer was held "entitled to invoke [Rule 10301] as an intended third-party beneficiary," while *Scobee Combs Funeral Home, Inc. v E.F. Hutton & Co., Inc.,* 711 F Supp. 605 (S.D. Fla. 1989; bit.ly/scobee-efhutt1989) found that the intent of the NASD Code was "to promote just and equitable principles of trade *for the protection of investors.*" (emphasis in original).

SHIFT IN INTERPRETATION

However, a recent line of cases has effectively whittled away at FINRA's efforts to provide investors access to the FINRA arbitration forum and has shielded brokerage firms from having to defend themselves in the FINRA forum. The court decisions in *Morgan Keegan & Co., Inc. v Silverman,* 706 F3d 562, 565 (4th Cir 2013) and *Goldman, Sachs & Co. v. City of Reno* (2014 WL 1272784 (9th Cir. Mar. 31, 2014); bit.ly/GoldSachs-Reno2014) typify the new direction.

These decisions stand for the proposition that FINRA's arbitration rule should be narrowly construed, is not entitled to the presumption of arbitrability, and is essentially second class. Though the decisions in a "customer" dispute case and a forum selection case use different reasons for their holdings, the outcome is similar: the elimination of investor choice in resolving securities disputes.

Recently, the Ninth Circuit issued a decision further solidifying the recent trend of cases limiting investor access to FINRA arbitration. In *Goldman, Sachs & Co. v. City of Reno,* 2014 WL 1272784 (9th Cir. Mar. 31, 2014; bit.ly/GoldSachs-Reno2014), the Ninth Circuit reversed the District Court for the District of Nevada's denial of a preliminary injunction in an action brought by Goldman, Sachs & Co. to enjoin FINRA arbitration initiated by Reno in connection with a dispute arising under underwriting and broker-dealer agreements for the issuance of municipal bonds in the form of auction rate securities. The appellate court held that forum selection clauses in the parties' contracts superseded any right to FINRA arbitration. The forum selection clause stated that "all actions and proceedings arising" out of the agreement were to be brought before the "United States District Court for the District of Nevada and that, in connection with any such action or proceeding, the parties shall submit to the jurisdiction of, and venue in, such court."

The panel determined that Reno had disclaimed its right to FINRA arbitration by agreeing to the forum selection clauses in the parties' agreements. The court found that "as a FINRA member, Goldman had a *default* obligation to arbitrate at the request of a 'customer'" (emphasis added). However, the court held that FINRA's arbitration clause was only a default obligation that can be contracted out of by the parties. Once contracted around, "Reno disclaimed any right to arbitrate that it might otherwise have had."

The Ninth Circuit noted that in cases involving nearly identical facts and forum selection clauses, the Fourth Circuit and the District of Minnesota (*UBS Fin.Servs., Inc. v. Carilion Clinic*, 706 F.3d 319 (4th Cir. 2013; bit.ly/ubscar2013) and *UBS Sec. LLC v. Allina Health Sys.*, No. 12-2090, 2013 WL500373 (D. Minn. Feb. 11, 2013; bit.ly/ubsall2013)), had both found that while forum selection clauses were capable of superseding a FINRA member's obligation to arbitrate under the FINRA Rules, the language of the clauses, which referred to "all actions and proceedings," was limited to court proceedings and did not encompass arbitration.

The Ninth Circuit, however, followed the reasoning of two Southern District of New York decisions (*Goldman, Sachs & Co. v. N.C. Mun. Power Agency No. One*, No. 13-CV-1319, 2013 WL 6409348 (S.D.N.Y. Dec. 9, 2013; bit.ly/goldsachsnc2013); *Goldman, Sachs & Co. v. Golden Empire Schools Fin. Auth.*, 922 F. Supp. 2d 435 (S.D.N.Y. 2013; bit.ly/goldsachsgoldemp2013)) that, because the presumption in favor of arbitrability did not apply here, the forum selection clauses needed only be sufficiently specific to impute to the contracting parties the reasonable expectation that they would litigate any disputes in federal court, thereby superseding Goldman's default obligation to arbitrate under FINRA Rule 12200. The dissent found the Fourth Circuit's reasoning in *Carilion Clinic* more persuasive, and would have held that greater specificity was required to waive the right to elect FINRA arbitration.

However, the Ninth Circuit decision rests upon the premise that FINRA's arbitration provision is a "default" contract that a member firm and a customer can contract around. First, as the Second Circuit in *Kidder, Peabody & Co., Inc. v. Zinsmeyer Trusts P'ship,* 41 F.3d 861, 864 (2d Cir. 1994) made clear, customers are "entitled to invoke [FINRA's arbitration clause] as an intended third-party beneficiary, in its dispute with Kidder" (citations omitted).

In *Kidder, Peabody,* the brokerage firm entered into an agreement with the customer to delete the arbitration provision in the investor's agreement with the firm. The firm argued that by deleting the arbitration provision the firm had made clear its intent not to submit the dispute to arbitration. However, the court held that even though Kidder, Peabody, struck the arbitration agreement written in the parties brokerage account agreement, "[t]he elimination of such a superseding clause, however, does not signify an intention to erase a pre-

"[A] recent line of cases has effectively whittled away at FINRA's efforts to provide investors access to the FINRA arbitration forum and has shielded brokerage firms from having to defend themselves in the FINRA forum."

existing obligation" – the NASD's agreement with Kidder, Peabody to submit customer disputes to arbitration at the election of the customer.

Therefore, the forum selection clauses in cases similar to *City of Reno,* ought to have no effect on a contract between FINRA and member firms to allow "customers" to "invoke" arbitration with the member. The holding in *City of Reno,* that FINRA's arbitration provision is a "default" arbitration agreement, is questionable at best. The option of arbitration should not be precluded by forum selection clauses.

Moreover, it is noteworthy that the *Reno* decision shies away from the language of "waiver," referring more often to the issue of "disclaimer" of the FINRA rule. The Supreme Court has held, in Moses Cone . . . ., that FAA "establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an *allegation of waiver*, delay, or a like defense to arbitrability" (emphasis added). If waiver is not a threshold issue, it is therefore entitled to the presumption of arbitrability, and a matter for arbitral, as opposed to judicial, determination.

INVESTOR CHOICE

It is also interesting that the courts deciding this issue have paid little or no attention to the investor-protection elements in the rulemaking history of FINRA Rule 12200, or the current popular and legislative debate on investor choice. If fairness requires investors to have a choice of forum in which to pursue complaints against broker-dealers, the FINRA arbitration rule should not be capable of being waived, or any waiver should at least have to be clear and express.

The *Dodd-Frank Wall Street Reform and Consumer Protection Act* (H.R. 4173, 111th Cong. (2010; bit.ly/dodd-frank2010) authorizes the SEC to issue rules limiting, imposing conditions on, or even entirely prohibiting agreements that require arbitration by customers of brokers, dealers, municipal securities dealers and investment advisers, "in the public interest *and for the protection of investors*" (emphasis added). Not content to wait for SEC action, in August 2013, Rep. Keith Ellison (D-MN), introduced in Congress the *Investor Choice Act of 2013* (H.R. 2998; bit.ly/InvestChoice2013). The Act would amend the Securities Exchange Act of 1934 (bit.ly/SEA34) to expressly prohibit mandatory pre-dispute arbitration agreements by brokers and dealers, and modify the Investment Advisers Act of 1940 to make it unlawful for any investment adviser to enter into an agreement with a customer that included a pre-dispute arbitration agreement. Although govtrack.us gives the bill a 1% chance of passage (bit.ly/1jpCur3), it has garnered support, in response to investor concerns about fairness in FINRA arbitration, and the general climate of suspicion surrounding all business-to-consumer pre-dispute arbitration agreements that has prompted introduction of the Arbitration Fairness Act (bit.ly/arbfair).

Thus, at the same time that the legislature is attempting to ensure that investors are not locked into a particular forum or mechanism until a dispute arises, the courts are allowing broker-dealers to foreclose the arbitration option by including forum selection clauses.

CONCLUSION

Recent FINRA arbitration decisions impose unworkable obstacles to resolving investor disputes and needlessly protract, delay, and hinder attempts by FINRA to enforce fair industry practices. FINRA arbitrability decisions now employ a unique second class interpretative model when compared to all other arbitration analysis. Recent decisions not only create an analytical divergence in determining issues of arbitrability between FINRA and non-FINRA arbitration disputes, but also harm investors by limiting their rightful option of arbitration and the enhanced protections for investors afforded under the FINRA Rules.