OPENING THE FLOODGATES OF SMALL CUSTOMER CLAIMS IN FINRA ARBITRATION: *FINRA V. CHARLES SCHWAB & CO., INC.*

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> "Currently, almost all customer agreements with brokerage firms include an arbitration clause requiring customers to arbitrate their claims in an arbitration forum—and they're now popping-up in the investment advisory industry. By adding such provisions, brokerage and advisory firms are essentially requiring their clients to give up their legal rights before the client even knows about the nature of a dispute, and before the client has had the opportunity to consider whether giving up those rights would be in their interest. The inclusion of such provisions in brokerage and advisory contracts diminishes investor protection."[1]

I. Introduction

When the Supreme Court held over twenty-five years ago that customers could be compelled to arbitrate their federal securities claims against their brokers,[2] the vast majority of financial firms in the U.S. inserted pre-dispute arbitration provisions ("PDAAs") in agreements with their customers requiring them to arbitrate any

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1 Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n ("SEC"), Outmanned and Outgunned: Fighting on Behalf of Investors Despite Efforts to Weaken Investor Protections, Speech before the North American Securities Administrators Association ("NASAA"): Annual NASAA/SEC 19(d) Conference (Apr. 16, 2013), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1365171515400#.UfmMlZWdzdk.

2 Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 226 (1987). The Court held that pre-dispute arbitration agreements were enforceable with respect to claims brought under the Securities Exchange Act of 1934 ("Exchange Act"). Only two years later, in Rodriguez de Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477 (1989), the Court extended that reasoning to claims brought under the Securities Act of 1933 ("Securities Act"), 490 U.S. at 483–84, expressly overruling Wilko v. Swan, 346 U.S. 427 (1953), long-standing Supreme Court precedent that had largely shielded federal securities claims from mandatory arbitration.

claims arising out of their brokerage relationship.[3] Since *Sheerson/ Am. Express, Inc. v. McMahon*, investor advocacy groups, scholars, and legislators have called for Congressional action to eliminate mandatory arbitration in securities cases,[4] but the closest Congress has come to such elimination has been to punt this issue to the Securities and Exchange Commission ("SEC"),[5] which has not yet acted. Instead, building upon the development of a uniform securi-

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3 *See* Barbara Black, *Can Behavioral Economics Inform Our Understanding of Securities Arbitration?*, 12 TENN. J. BUS. L. 107 (2010), *available at* http://ssrn.com/abstract=1647063; Jill I. Gross, *The End of Mandatory Securities Arbitration?*, 30 PACE L. REV. 1174, 1180 (2010); SECURITIES ARBITRATION REFORM: REPORT OF THE ARBITRATION POLICY TASK FORCE TO THE BOARD OF GOVERNORS NAT'L ASSOC. OF SECURITIES DEALERS, INC., 3 (1996), also known as the "Ruder Report", *available at* http://www.lgesquire.com/NASD_RuderReport.pdf.

4 Constantine N. Katsoris, *Roadmap to Securities ADR*, 11 FORDHAM J. CORP. & FIN. L., 413, 419–20 (2006). Since 2007 there have been repeated efforts to amend the Federal Arbitration Act, 9 U.S.C. §§ 1–14, to preclude or invalidate mandatory arbitration agreements in consumer and investor contracts, employment and civil rights claims. Jill I. Gross, *McMahon Turns Twenty: The Regulation of Fairness in Securities Arbitration*, 76 U. CINN. L. REV. 493, 498 (2008); *see also* George H. Friedman, *The Arbitration Fairness Act of 2013: A Well-Intended but Potentially Dangerous Overreaction to a Legitimate Concern,* SEC. ARB. COMMENTATOR 1 (June 2013), *available at* http://www.proffriedman.com/files/SAC_AFA_Article__final_06-2013_.pdf. The current Senate and House versions of the Arbitration Fairness Act of 2013 ("AFA"), S. 987, *available at* http://www.govtrack.us/congress/bills/113/s878, and H.R. 1844, *available at* http://www.govtrack.us/congress/bills/113/hr1844, were proposed on May 7, 2013. The co-sponsors of the bills in the Senate and House, Senator Al Franken (D-MN) and U.S. Representative Hank Johnson (D-GA), expressly referenced AT&T Mobility, LLC v. Concepcion, 131 S. Ct. 1740 (2011) and other recent Supreme Court cases (including the then-anticipated adverse ruling in Am. Express Co. v. Italian Colors Rest., 570 U.S. ______, 133 S. Ct. 2304, 2013 WL 3064410 (2013)), that "erode[d] the rights of consumers" and allowed companies to "insulate themselves from liability" through the use of mandatory predispute arbitration provisions that had the effect, under the Court's recent rulings, to bar consumers' participation in judicial class actions. *See* Press Release, *Rep. Johnson, announcing reintroduction of AFA*, OFFICE OF REPRESENTATIVE HANK JOHNSON (May 7, 2013), *available at* http://hankjohnson.house.gov/press-release/rep-johnson-re-introduces-bill-protect-legal-rights-consumers; *see also* Press Release, Sen. Franken, *The Arbitration Fairness Act of 2013 (statement on the AFA*), OFFICE OF SENATOR FRANKEN, *available at* http://www.franken.senate.gov/files/documents/130507ArbitrationFairness.pdf (last visited Feb. 10, 2014).

5 As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"), Pub. L. No. 111-203, 124 Stat. 1376, Congress gave the SEC authority to limit or prohibit arbitration provisions in agreements between customers and their broker dealers or investment advisors. Section 921, 15 U.S.C. § 78o, amended Section 15 of the Securities Exchange Act of 1934 ("Exchange Act"), to provide the SEC with the authority to restrict or prohibit mandatory pre-dispute arbitration with respect to claims arising under the federal securities law and rules of a self-regulatory organization: "The Commission, by rule, may prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of any broker, dealer, or municipal securities dealer to arbitrate any future dispute between them arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors." Dodd-Frank Act, Pub. L. No. 111-203, § 921(a), 124 Stat. 1841 (2010). It similarly amended Section 205 of the Investment

ties arbitration code and other reforms that pre-dated *McMahon*,[6] the SEC has prodded self-regulatory organizations ("SROs") to make significant reforms to its arbitration rules that have improved the arbitration process to make it fairer to investors.[7]

Today, nearly all customer disputes are resolved through arbitration before the Financial Industry Regulatory Authority ("FINRA"),[8] the largest arbitral forum for the resolution of securities disputes between member firms and their customers.[9] Under the regulatory oversight of the SEC, FINRA has established a uniform, streamlined set of rules for the arbitration of customer disputes designed to provide fairness, procedural protections, and access to remedies customers would otherwise be able to obtain in

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Advisers Act of 1940, 15 U.S.C. § 80b-5, to provide the SEC with the same authority with respect to agreements between investors and their investment advisers. *Id.*

In addition, Dodd-Frank created a new federal agency to protect consumers' financial interests, the Consumer Financial Protection Bureau ("CFPB"), and charged the agency with studying the use of binding arbitration clauses in consumer financial services contracts. Dodd-Frank Act, Pub. L. No. 111-203, § 1011, 124 Stat. 1964. Dodd-Frank also included an outright ban on the use of arbitration clauses in mortgage contracts. *Id.* § 2149.

6 *See infra* notes 32–34 and accompanying discussion.

7 The SEC's regulatory oversight of SROs' rulemaking process, including review and approval of procedural rules governing arbitral forums, distinguish arbitration of securities disputes from arbitration of consumer, employment and other commercial matters. Barbara Black & Jill I. Gross, *Investor Protection Meets the Federal Arbitration Act*, 1 Stan. J. Complex Litig. 1, 5 (2012). Since *McMahon*, there have been significant improvements to securities arbitration to make the process fairer to investors, including providing prominent disclosure of PDAAs in customer agreements that explain the process of arbitration and its consequences. *Id.* at 5–6; Barbara Black, *The Irony of Securities Arbitration Today: Why do Brokerage Firms Need Judicial Protection?*, 72 U. Cin. L. Rev. 415, 446–53 (2003) (discussing significant procedural reforms). *See infra* notes 35–44 and accompanying discussion.

8 FINRA is a private, not-for-profit corporation functioning as a self-regulatory organization registered with the Securities and Exchange Commission. FINRA was formed in July 2007 by the consolidation of National Association of Securities Dealers ("NASD") and the regulatory arm of the New York Stock Exchange ("NYSE"). Alan Lawhead, *Useful Limits to the Fifth Amendment: Examining the Benefits That Flow From a Private Regulator's Ability to Demand Answers to its Questions During an Investigation*, 2009 Colum. Bus. L. Rev. 210, 212 (2009). FINRA is responsible for regulatory oversight of broker-dealers in the U.S. *Id.* at 213–14; *see also* Karsner v. Lothian, 532 F.3d 876, 880 (D.C. Cir. 2008) ("FINRA, as NASD's successor, is 'the only officially registered 'national securities association' under [the Exchange Act].'") (citation omitted). All broker dealers must be registered with FINRA. Exchange Act § 15(b)(8), 15 U.S.C. § 78o(b)(8); Fiero v. FINRA, 660 F.3d 569, 571 (2d Cir. 2011).

9 *See Arbitration & Mediation*, Finra, http://www.finra.org/ArbitrationAndMediation/index.htm (last visited Sept. 2, 2013); FINRA Dispute Resolution provides an arbitration forum for customer disputes and industry disputes such as those between broker dealers and associated persons, or between two or more broker dealers. Prior to the creation of FINRA, the vast majority of securities disputes were filed before the NASD. Jill. I. Gross, *Securities Mediation: Dispute Resolution for the Individual Investor*, 21 Ohio St. J. on Dis. Resol. 329, 337 (2006) (after *McMahon* and *Rodriguez de Quijas*, most customer disputes were resolved in arbitration in an SRO-sponsored forum, more than 90% before the NASD).

court.[10] Fundamental to the regulatory oversight of its dispute resolution system, efficiency, and fairness to customers, is the requirement that all FINRA members who choose to use PDAAs (a nearly universal choice) are prohibited from limiting or abrogating any of the procedural and substantive remedies otherwise available to customers.[11]

One of those remedies is the availability of a judicial forum for customers to bring or participate in a class action. Since 1992, the SROs have included provisions (now embodied in FINRA's Code of Arbitration Procedures for Customer Disputes [the "Customer Code"]), precluding representative actions in arbitration and further providing that members may not compel arbitration of any claim subject to a judicial class action unless that claim is removed from the class action.[12] In its adopting release, the SEC agreed with the NASD that "class actions are better handled by the courts and that investors should have access to the courts to resolve class actions efficiently."[13]

Thus, the financial industry understood that it could not place judicial class action waivers in their customer agreements without running afoul of SRO conduct rules.[14] However, in October 2011, emboldened by the Supreme Court's decision in *AT&T Mobility v. Concepcion*,[15] Charles Schwab & Co., Inc. ("Schwab") amended nearly seven million customer agreements to include a waiver of customers' rights to bring judicial class actions and, further, to preclude consolidation of customer claims in arbitration.[16] In short, Schwab's waiver provision required that customers bring their claims, if any, in arbitration solely on an individual basis.

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10 The SEC pushed SROs for a "litigation" model of arbitration, designed to provide procedural protections. Barbara Black, *Is Securities Arbitration Fair to Investors?*, 25 PACE L. REV. 1, 5–6 (2004) (procedural protections include providing reasonable notice to the customer that he or she is entering into a PDAA, right to representation of counsel, to present evidence at a hearing geographically convenient to the customer). *See also infra* notes 34–36 and accompanying discussion.

11 FINRA Rule 2268(d). *See infra* notes 45–48 and accompanying discussion.

12 These prohibitions are now found in FINRA Rule 12204(a) and 12204(d); *see also infra* notes 49–55 and accompanying discussion.

13 SEC approving release for amendments to NASD Code of Arbitration Procedure and Rules of Fair Practice, Exchange Act Rel. No. 31371, 1992 SEC LEXIS 2767, 57 Fed. Reg. 42659 (Oct. 28, 1992).

14 Black & Gross, *supra* note 7, at 27–28; *see also infra* note 52.

15 131 S. Ct. 1740 (2011).

16 Complaint and Request for Expedited Hearing ¶¶ 12–14, FINRA Office of Hearing Officers, Dep't of Enforcement v. Charles Schwab & Co., Disciplinary Proceeding No. 2011029760201 (Feb. 1, 2012), *available at* http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=29288 [hereinafter *Schwab* Compl. & Request for Expedited Hearing].

Predictably, FINRA's Department of Enforcement ("Enforcement") filed an enforcement action claiming violations of its member conduct rules prohibiting its members from inserting language in their PDAAs that limit customers' rights under FINRA's forum rules, including the ability to file judicial claims not otherwise prohibited by FINRA, i.e., class actions.[17] The Office of Hearing Officers ("the Panel") agreed with Enforcement that Schwab had, in fact, violated the conduct rules as alleged, but refused to enforce the rules prohibiting waiver of class actions reasoning that, under the U.S. Supreme Court's recent decision in *Concepcion,* the conduct rules were unenforceable under the Federal Arbitration Act ("FAA").[18]

Aside from the Panel's stunning refusal to enforce FINRA's Conduct Rules,[19] the *Schwab OHO Decision* is fundamentally flawed because it all but ignores the member agreement between FINRA and Schwab and, instead, focuses on the agreement between Schwab and its customers—which was not directly being challenged. This is a significant, critical distinction between the *Schwab* enforcement proceeding and cases where the judicial class action waiver is directly being challenged by the customer or consumer subject to the waiver, as presented by *Concepcion* and the Supreme Court's most recent case on this issue, *American Express Co. v. Italian Colors Restaurant.*[20] In contrast to those cases, the customers subject to the PDAA in Schwab's agreement were not challenging or resisting its enforcement. Instead, FINRA brought

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17 *Id.* at ¶¶ 20, 26 & 32 (setting forth three causes of action against Schwab; the first two causes of action alleged violations stemming from Schwab's prohibition of judicial class actions, and the third cause of action related to Schwab's prohibition against consolidation of claims in arbitration).

18 Hearing Panel Decision Granting in Part and Denying in Part The Parties' Cross Motions for Summary Disposition, FINRA Office of Hearing Officers, Dep't of Enforcement v. Charles Schwab & Co., Disciplinary Proceeding No. 2011029760201, 2013 WL 1463100 at *1 (Feb. 21, 2013). The FAA, 9 U.S.C. §§ 1–14, governs agreements to arbitrate involving "transactions in commerce," 9 U.S.C. § 2. As Professors Black and Gross observe, the past four decades of Supreme Court jurisprudence "has catapulted the FAA to super-status: it governs virtually every arbitration clause arising out of a commercial transaction, applies in both state and federal court, compels the arbitrability of federal statutory claims, permits arbitrators to rule on the unconscionability of the arbitration clause, and preempts any state law that 'actually conflicts with federal law—that is, to the extent that it 'stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'" Black & Gross, *supra* note 7, at 11–12 (citations omitted).

19 FINRA is required to enforce compliance with its own rules and may be sanctioned by the SEC for failure to do so. Exchange Act §19(h), 15 U.S.C. § 78s(h); *see also infra* notes 106–112 and accompanying discussion.

20 133 S. Ct. 2304 (2013).

an action to enforce its own member agreement with Schwab (which is itself an arbitration agreement), under which Schwab agreed to certain restrictions in exchange for the benefit of membership. By elevating Schwab's customer agreement over its member agreement with FINRA, the Panel's ruling is actually inconsistent with the FAA and Supreme Court precedent requiring strict enforcement of the parties' arbitration agreements.[21]

The *Schwab OHO Decision* immediately reignited calls for a ban on mandatory pre-dispute arbitration provisions in consumer and investor contracts.[22] The case is being closely watched by the financial industry, and will likely end up before a Supreme Court that is increasingly hostile to judicial class actions and has all but closed the door on the effective vindication doctrine with its most recent decision in *Italian Colors*.[23] But the regulatory and contextual differences between *Schwab* and the Supreme Court line of cases provide hope that FINRA's conduct rules prohibiting class action waivers will stand as enforceable and, therefore, remain in the standard PDAA found in customer agreements with their brokers.

Should the *Schwab* decision ultimately stand,[24] however, the consequences to smaller claim investors could be devastating given the line of cases from *Concepcion* to *Italian Colors*. Many inves-

21 *See infra* notes 95–105 and accompanying discussion.

22 Several days after the decision was released, a group of thirty-seven U.S. Senators and Congressmen led by Senator Al Franken (D-Minn.) sent a letter to the SEC urging it to act under Section 921 of Dodd Frank Act to prevent mandatory arbitration provisions in broker-customer contracts, stating:

> We are deeply concerned that the Commission's failure to respond to the dangers posed by widespread forced arbitration will weaken existing investor protections. Given the uncertainty created by the recent FINRA decision, we urge the Commission to act quickly to exercise its authority under Section 921 to prevent this practice and protect investor rights.

See Letter from Sen. Franken to the SEC, OFFICE OF SENATOR FRANKEN (Apr. 30, 2013), *available at* http://www.franken.senate.gov/?p=press_release&id=2381.

23 *Italian Colors*, 133 S. Ct. at 2309; *see infra* notes 127–145 and accompanying discussion.

24 Enforcement has appealed the *Schwab OHO Decision* to the National Adjudicatory Council ("NAC"), which hears initial appeals from disciplinary actions. FINRA Code of Civil Procedure, Rule 9310–11. Should the NAC reverse the Panel's decision, Schwab may appeal to the SEC, *id.* Rule 9370, or the SEC may initiate review on its own. Exchange Act § 19(d)(2), 15 U.S.C. § 78s(d)(2). Should the SEC issue a ruling adverse to Schwab, it can then file an appeal of the decision in the Circuit Court of Appeals for the district in which it resides or does business, or before the District of Columbia Court of Appeals, Exchange Act § 25(a), 15 U.S.C. § 78y, and thereafter, to the U.S. Supreme Court. *See* Black & Gross, *supra* note 7, at n. 53 (noting that Section 25(a) provides for plenary review of SEC disciplinary actions to "aggrieved persons," which does not include FINRA acting in its adjudicative capacity) (citing NASD, Inc. v. SEC, 431 F.3d 803 (D.C. Cir. 2005)).

tors will be left with the choice of pursuing their claims pro se through a complex arbitral system or abandoning them altogether.[25] This unfortunate result will add pressure on the SEC to exercise its authority under Dodd-Frank to limit or bar the use of mandatory PDAAs which, as explained below, may be counterproductive to the goal of fair and efficient resolution of investor claims.[26]

Part II of this Article will provide a brief background of the regulatory framework governing the brokerage industry and its use of PDAAs in agreements with customers, and FINRA's limitations on judicial class action waivers. Part III will set forth the facts setting up the conflict between FINRA and Schwab and examine the *Schwab OHO Decision*. The reasons why the *Schwab OHO Decision* is flawed and should ultimately be reversed are set forth in Part IV of this Article. Finally, Part V will explore the consequences to investors with small claims should judicial class action waivers ultimately be held enforceable in securities cases, and alternative proposals FINRA can explore to provide avenues for the efficient resolution of investors' claims.

II. FINRA Rules Provide For Judicial Class Actions

The Exchange Act "established a complex scheme to regulate and maintain the capital markets as well as to protect the investing public,"[27] and created the SEC to administer and provide regulatory oversight.[28] The Exchange Act requires all broker-dealers that effect transactions in interstate commerce to register with the

25 Although FINRA has a simplified arbitration procedure for claims under $50,000, which provides for resolution of claims solely on the parties' pleadings and without a hearing, FINRA Rule 12800, as explained *infra* at notes 155–163 and accompanying discussion, this process has important limitations and, for many investors, is still too complex to navigate without assistance.

26 *See infra* notes 150–154 and accompanying discussion.

27 Gross, *supra* note 9, at 345. Prior to the creation of the SEC, securities industry professionals were subject to standards of conduct set by SROs, which began as purely private membership organizations. Robert S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 Stan. J. L. Bus. & Fin. 151 (2008). The NYSE was organized in 1792, and the NASD was formed in 1936, as a Delaware corporation, after the reorganization of a trade group known as the Investment Bankers Association of America. *Id.* at 159.

28 Exchange Act § 4, 15 U.S.C. § 78d (2006) (creating the SEC), and *see generally id.* at §§ 15, 19, 15 U.S.C. 78o, s.

SEC,[29] to become members of an SRO,[30] to abide by its rules and be subject to the SRO's regulatory processes and enforcement actions.[31] The 1975 Amendments to Section 19 of the Exchange Act provided the SEC with direct authority over the SROs' rulemaking processes, including authority to review, approve, modify or vacate any rule, including rules governing their respective, arbitral forums.[32]

As a result, by the time the Supreme Court considered *McMahon*, the SEC filed an amicus brief in support of arbitration of securities disputes, explaining that its newly granted authority under Section 19 of the Exchange Act could ensure the fairness and adequacy of SROs' arbitration procedures and enforce customers' rights under the Exchange Act.[33] Thereafter, the SEC and SROs recognized the importance of making reforms to improve fairness to investors, efficient resolution of disputes in arbitration, and to

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29 *Id.* at § 15(a), 15 U.S.C. § 78o-3; Section 15(b) provides the SEC with broad authority to limit, censure, suspend or bar broker-dealers and associated persons for violations of the federal securities laws, rules and regulations. *Id.* § 15(b), 15 U.S.C. 78o-4.

30 *Id.* at § 15(b)(8), 15 U.S.C. § 78o(b)(8).

31 *Id.* at § 19(h)(1), 15 U.S.C. § 78s(h)(1); Lawhead, *supra* note 8, at 221–22.

32 Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97; *see* Karmel, *supra* note 27, at 162 (the 1975 Amendments greatly expanded the role of the SEC in providing regulatory oversight by, among other things, giving the SEC rulemaking oversight, expanding its role in SRO enforcement and discipline, and providing for the SEC to "play an active role in structuring the capital markets."). Indeed, in *McMahon*, the Supreme Court pointed to the 1975 Amendments as one of the most significant changes since *Wilko* in the "regulatory structure of the securities laws." Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 233–34 (1987). Because the Amendments provided the SEC with direct oversight to ensure that SROs implemented fair and sound arbitration procedures for the resolution of securities disputes:

> Since the 1975 amendments to § 19 of the Exchange Act . . . the Commission has had expansive power to ensure the adequacy of the arbitration procedures employed by the SROs. No proposed rule change may take effect unless the SEC finds that the proposed rule is consistent with the requirements of the Exchange Act; and the Commission has the power, on its own initiative, to "abrogate, add to, and delete from" any SRO rule if it finds such changes necessary or appropriate to further the objectives of the Act. In short, the Commission has broad authority to oversee and to regulate the rules adopted by the SROs relating to customer disputes, including the power to mandate the adoption of any rules it deems *necessary to ensure that arbitration procedures adequately protect statutory rights*.

McMahon, 482 U.S. at 233–34 (citing 15 U.S.C. §§ 78s(b)(2), (c)) (emphasis added). "The 1975 Amendments to the 1934 Act added an indispensable layer of statutory regulation over SRO arbitration . . . with the express statutory purpose of enhancing investor protection." Gross, *supra* note 9, at 347.

33 Brief for the SEC as Amicus Curiae, at 6–7, Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220 (1987) (No. 86-44), 1986 WL 727882.

improve investor perception that arbitration is unfair.[34] As described by Professor Gross, in the first decade after *McMahon*, the SEC approved numerous rule proposals designed to "level the playing field and address criticisms of the process from investor advocates," while the second decade focused on implementing virtually every one of the over seventy reforms suggested in the 1996 Ruder Report.[35]

FINRA has continued those efforts through its rules consolidation process and additional reforms to improve the process and sense of fairness to investors.[36] During the last five years alone, the SEC has approved new rules or amendments to existing rules of the Customer Code designed to simplify and increase customers' access to the FINRA arbitration process and enhance their perception of fairness of the arbitration process, including:

- Amending the definition of "public arbitrator" to ensure that individuals with ties to the securities industry may not serve as public arbitrators,[37] and providing customers with

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34 Black & Gross, *supra* note 7, at 18–19 (discussing extensive history of ongoing reform of arbitration rules under SEC oversight, under NASD, FINRA's predecessor, and continuing under FINRA).

35 Gross, *supra* note 4, at 496.

36 Following the consolidation of the NASD and NYSE Regulation, FINRA commenced a process to develop a new "Consolidated Rulebook" of FINRA Rules that includes both NASD and NYSE rules. *Information Notice*: *Rulebook Consolidation Process*, FINRA 1 (Mar. 12, 2008), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p038121.pdf. FINRA's consolidation process has involved streamlining and harmonizing the NASD and NYSE rules, with a view towards ensuring that FINRA's rules reflect its "core mission of investor protection and market integrity." *Id.* All new FINRA rules issued as a result of the consolidation process have been reviewed and approved by the SEC after a comment process. *Information Notice: Rulebook Consolidation Process*, FINRA 1 (Oct. 8, 2008), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117155.pdf. The first FINRA rules became effective Dec. 15, 2008. *Regulatory Notice 08-57: Rulebook Consolidation Process*, FINRA 1 (Oct. 2008), https://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117255.pdf.

37 *Regulatory Notice 08-22*, *Definition of Public Arbitrator, SEC Approves Rule Change to Amend the Definition of Public Arbitrator in the Arbitration Codes for Customer and Industry Disputes*, FINRA 1 (May 2008), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p038472.pdf (announcing amendments to the definition of public arbitrator in the Customer Code (Rules 12100(u)) and corresponding Industry Code (Rules 13100(u)) which added a revenue limitation of $50,000 to the definition of public arbitrator). The amendments disqualify any attorney, accountant or other professional whose firm receives more than $50,000 in annual revenue over the prior two years from services provided to the financial industry or other persons already disqualified from serving as a public arbitrator. The Regulatory Notice further instructed arbitrators to update their disclosures in light of the new requirements, and that they were under an ongoing obligation to disclose. *See also Regulatory Notice 13-21, Public Arbitrator Definition, SEC Approves Amendments to Arbitration Codes to Revise Definition of Public Arbitrator*, FINRA 1 (June 2013), *available at* http://www.finra.org/

the option of an "all public" arbitration panel;[38]

- Reducing the costs of FINRA arbitration on smaller claims by increasing the monetary limits for simplified arbitration proceedings,[39] single arbitrator panels,[40] and greater flexibility as to hearing location;[41]
- Simplifying the discovery process through a presumptive automatic exchange of documents on customer and industry lists of documents set forth in FINRA's Discovery Guide;[42]

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web/groups/industry/@ip/@reg/@notice/documents/notices/p272613.pdf (amending FINRA Rules 12100(u) (Customer Code) and 13100(u) (Industry Code) to exclude persons associated with a mutual fund or hedge fund from serving as a public arbitrator).

38 *Regulatory Notice 11-05, Arbitration Panel Composition, Customer Option to Choose an All Public Panel in All Cases,* FINRA 1 (Feb. 2011), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122879.pdf (announcing new Rules 12402 and Rule 12043 (consolidating former FINRA rules on arbitrator panel composition and selection) providing customers with the option of selecting an "all public" panel in cases requiring three arbitrator panels (claims over $100,000)). The Regulatory Notice explained that "providing customers with the right to exclude a non-public arbitrator from the panel deciding their case will enhance customers' perception of the fairness of FINRA's rules and the securities arbitration process." *Id.* Initial studies conducted indicate that the all public panels have been favorable to customers, increasing their recovery rate approximately 40%. Howard B. Prossnitz, *Who Wins FINRA Cases and Why*, 19 PIABA BAR J. 141, 151–52 (2012) (reviewed cases resolved in 2011 and noted that all public panels increased the win rate for customers from 45.6% to 63%; FINRA's own review of cases produced consistent results, a win rate increase from 44% to 62%).

39 *Regulatory Notice 12-30, Simplified Arbitration, SEC Approves Amendments to Arbitration Codes to Raise the Limit for Simplified Arbitration from $25,000 to $50,000*, FINRA 1 (June 2012), *available at* http://www.finra.org/webgroups/industry/@ip/@reg/@notice/documents/notices/p127156.pdf (amending FINRA Rule 12800 (Customer Code)). FINRA's simplified arbitration procedures for small claims provide for a cost-effective, streamlined dispute resolution process through which a single arbitrator resolves the dispute between the parties and issues and award based solely on the written submissions of the parties. The customer still has the option of requesting a hearing in a simplified proceeding.

40 *Regulatory Notice 09-13, Threshold for Single Arbitrator Cases, SEC Approves Amendments Raising the Threshold for Single Arbitrator Cases $100,000*, FINRA 1 (Feb. 2009), *available at* ,http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p118034.pdf (amending FINRA Rule 12401 (Customer Code) and Rule 13401 (Industry Code) to raise the amount in controversy for appointing a single chair-qualified arbitrator from $50,000 to $100,000). FINRA explained that the amendments would "streamline the dispute resolution process and decrease costs for users of the forum." *Id.* at 2.

41 *Regulatory Notice 10-17, Hearing Locations, Amendments to the Arbitration Rules on Hearing Locations*, FINRA 1 (April 2010), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121222.pdf (amending FINRA Rule 12213 (Customer Code) to provide customer with option to request hearing location closest to his or her residence).

42 *Regulatory Notice 11-17*, *Arbitration, Revised Discovery Guide and Document Production Lists for Customer Arbitration Proceedings*, FINRA 1 (Apr. 2011), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p123505.pdf. In 1999 the NASD established a "Discovery Guide," for use in arbitrations, which includes Document Production Lists setting forth categories of documents that the parties are to automatically exchange within

- Significantly limiting the grounds upon which motions to dismiss may be granted prior to a hearing, thereby assuring that most customer claims be reviewed on the merits;[43] and
- Requiring arbitration panels to provide "reasoned awards" upon the parties' request.[44]

A fundamental component of the regulatory scheme governing securities arbitration is that member firms are prohibited from altering procedural rules or substantive claims and remedies through its PDAA. As early as 1989, the NASD and other SROs adopted rules to prevent members from inserting any provisions in PDAAs that would limit or contradict any rules of the SRO in an effort to address issues of "fairness and efficiency in the arbitration process."[45] As the SEC explained in its adopting release:

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sixty days after the answer is due, and are, therefore, presumptively discoverable. *Id.* The 2011 revisions to the Discovery Guide expanded FINRA's guidance on discovery and simplified the process by combining fourteen lists (two general and twelve that were based on specific types of claims) into two lists of "presumptively discoverable" documents—one for firms/associated persons, and the other for customers. *Id.*

43 *Regulatory Notice 09-07, SEC Approves New Motion to Dismiss Rule and Amendment to the Eligibility Rule in Arbitration; FINRA Imposes Immediate 30-Day Moratorium on Motions to Dismiss*, FINRA 1 (Jan. 2009), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117757.pdf (adopting new FINRA Rules 12504 (Customer Code) and 13504 (Industry Code), governing motions to dismiss in arbitration, and amending existing 12206 (Customer Code) and 13206 (Industry Code), which set forth jurisdictional eligibility requirements for arbitration). Among the goals of the new rules and amendments was to "ensure that parties have their claims heard in arbitration by significantly limiting motions to dismiss filed prior to the conclusion of a party's case-in-chief and by imposing strict sanctions against parties for engaging in abusive practices under the rules." *Id.* at 2. The new rules limited the grounds for dismissal of a claim prior to a hearing on the merits to three grounds: 1) the non-moving party previously released the claim in a signed settlement agreement or written release; 2) the moving party was not associated with the account(s), securities or conduct at issue; or 3) the claim does not meet the criteria of the eligibility rule. *Id.* at 4. FINRA proposed the new rules and amendments in response to concerns that respondents were routinely filing motions to dismiss, thereby making arbitration far more costly and time-consuming, and that the practice was increasing. *Id.* at 3–4.

44 *Regulatory Notice 09-16, Explained Arbitration Decisions, SEC Approves Amendments to Require Arbitrators to Provide an Explained Decision at Parties' Joint Request*, FINRA 1 (Mar. 2009), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p118141.pdf (amending FINRA Rules 12214, 12514 and 12904 (Customer Code) and 13214, 13514 and 13904 (Industry Code), requiring arbitrators to provide an explained decision if requested by both parties at least twenty days before the first scheduled hearing date). FINRA stated in the notice that the lack of explanations in awards "has been a common complaint of non-prevailing parties . . . especially customers and associated persons." *Id.* at 2.

45 In 1989 the arbitration rules of SROs were amended to prohibit "any language" in a PDAA that limits or contradicts the arbitration rules of any SRO. *See* Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc., National Association of Securities Dealers, Inc. and the American Stock Exchange, Inc. Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, SEC Rel. No. 34-26805, 54 Fed. Reg. 21144, 1989

> [T]he proposed rules appropriately balance the need to strengthen investor confidence in the arbitration systems at the SROs, both by improving the procedures for administering the arbitrations and by creating clear obligations regarding use by SRO members of predispute arbitration clauses, with the need to maintain arbitration as a form of dispute resolution that provides for equitable and efficient administration of justice.[46]

This prohibition is embodied today in FINRA Rule 2268 (taken from former NASD Rule 3110), which sets forth the requirements to its members when using PDAAs for customer accounts. Among other things, the rule sets forth requirements concerning specific cautionary language and disclosures that must be included in customer agreements that contain a PDAA and, further, provides instruction on where and how the disclosures should be placed in the agreement.[47] Importantly, subsection (d) of the rule prohibits members from inserting any provision in their PDAA that "limits or contradicts the rules of any self-regulatory organization."[48] And although the rule does not expressly address judicial class actions, it prohibits members from including in their PDAAs "any condition that . . . limits the ability of a party to file

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SEC LEXIS 843, at *1 (May 10, 1989) [hereinafter 1989 Approving Release]. NASD members were informed in an August 1989 Notice To Members ("NTM") that the amendments included an express prohibition on the use of language that would "limit" or "contradict" an SRO's arbitration rules. NTM 89-58, 1989 NASD LEXIS 107, at *2–3 (Aug. 1989). The SEC observed that this provision benefitted investors, explaining that:

> "Agreements cannot be used to curtail any rights that a party may otherwise have had in a judicial forum. If punitive damages or attorneys' fees would be available under applicable law, then the agreement cannot limit parties' rights to request them, nor arbitrators' rights to award them. The agreements may not be used to shorten applicable statutes of limitation, restrict the situs of an arbitration hearing contrary to SRO rules, nor to limit SRO forums otherwise available to parties." 1989 Approving Release, 1989 SEC LEXIS at *61.

46 *Id.* at *63–64.

47 FINRA Rule 2268(a) requires that any PDAA be highlighted and preceded by language expressly set out in the rule that alerts customers to the fact that the agreement contains and PDAA and the consequences of entering into an arbitration agreement, including, that: (1) the customer is giving up their right to sue in court, and right to trial by jury; (2) arbitration is binding and that there are limited grounds for reversal or modification of an award; (3) discovery is more limited in arbitration; (4) arbitrators do not have to explain their awards unless all parties to the arbitration request a reasoned award; (5) the panel may include a minority of members affiliated with the industry; (6) arbitration forum may impose time limitations for bringing a claim; and (7) the rules of the arbitration forum are incorporated into the PDAA. FINRA Rule 2268(a), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9955.

48 *Id.* at 2268(d)(1).

any claim in court permitted to be filed in court under the rules of the forums in which a claim may be filed under the agreement."[49]

A class or representative action is the type of action "permitted to be filed in court" under the rules of FINRA, because FINRA Rule 12204 proscribes class actions in arbitration.[50] Rule 12204 also prohibits the arbitration of claims being litigated against the same defendants in a judicial class action, or the enforcement of an arbitration agreement against a customer who is a member of a judicial class action, unless the customer files a notice with FINRA establishing that he or she is not participating in the class action.[51] The industry has generally understood that when Rule 12204(d) is read together with FINRA Rule 2268(d)(3) (and their predecessor NASD rules), judicial class actions are permitted and any provision that would limit or waive the customer's ability to bring or participate in a class action is invalid.[52]

Indeed, the SEC and SROs have recognized since the early 1990s that arbitral forums were ill-equipped to handle collective claims and, based on rule changes proposed by the Securities Industry Committee on Arbitration ("SICA") for the Uniform Code of Arbitration, the SEC agreed that investors should have the ability to seek redress of small claims in judicial class actions.[53] As the

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49 *Id.* at 2268(d)(3).

50 FINRA Rule 12204(a), *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=5189&element_id=4110&highlight=elects#r5189.

51 *Id.* at 12204(b)–(c). Subsection (b) prohibits arbitration of claims that are "based upon the same facts and law" and involve the same defendants, as in a judicial class action, unless the customer files with FINRA a copy of the customer's opt-out notice filed with Court or otherwise a notice that the customer will not participate in the judicial class action or any recovery therefrom. Subsection (d) bars enforcement of an arbitration agreement against a customer who is also a member of a certified or putative class "with respect to any claim that is the subject of the certified or putative class action *until*:

- The class certification is denied;
- The class is decertified;
- The member of the certified or putative class is excluded from the class by the court; or
- The member of the certified or putative class elects not to participate in the class or withdraws from the class according to conditions set by the court, if any." *Id.* 12204(d).

52 Dep't of Enforcement v. Charles Schwab & Co., Disciplinary Proceeding No. 2011029760201, 2013 WL 1463100 at * 11 ("For two decades, the industry has understood [Rules 2268(d)(3) and 12204(d), and their NASD predecessor rules] to operate together to preserve customers' ability to bring or participate in judicial class actions.").

53 SEC Order Approving Proposed Rule Change Relating to the Exclusion of Class Actions From Arbitration Proceedings, approving amendments to the NASD Code of Arbitration Procedure and Rules of Fair Practice, Exchange Act Release No. 34-31371, 1992 SEC LEXIS 2767, 57 Fed. Reg. 42659 (Oct. 28, 1992) [hereinafter SEC Order Relating to the Exclusion of Class Actions from Arbitration Proceedings] (approving NASD rule amendments to rules that form the precursor of FINRA Rules 12204(a) and 12204(d)). *But see* Bradley J. Bondi, *Facilitating Eco-*

SEC explained in approving the proposed amendments to preserve judicial class actions:

> Over the years of the evolution of class action litigation, the courts have developed the procedures and expertise for managing class actions. Duplication of the often complex procedural safeguards necessary for these hybrid lawsuits is unnecessary. The Commission believes that investor access to the courts should be preserved for class actions and that the rule change approved herein provides a sound procedure for the management of class actions arising out of securities industry disputes between NASD members and their customers.[54]

The SEC tacitly recognized that class actions serve an important role in investor protection, and the new amendments reflected "an efficient allocation of resources between two dispute resolution systems."[55]

III. Schwab Challenges FINRA Conduct Rules Prohibiting Class Action Waivers

A. *AT&T Mobility v. Concepcion*

The *Concepcion*[56] case squarely placed at issue the enforceability of a class action waiver in an arbitration agreement when, as alleged by plaintiffs, the size of the individual claims would be far outweighed by the costs of individual litigation. Customers that had entered into a service contract with AT&T brought a class ac-

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nomic Recovery and Sustainable Growth Through Reform of the Securities Class-Action System: Exploring Arbitration as an Alternative to Litigation, 33 Harv. J.L. & Pub. Pol'y 607, 624 (2010) (arguing that the SEC did not base its approval of proposed rule out of a concern over the integrity of the arbitration process, but rather, based on a recognition that the federal judicial system already had developed procedures to manage class actions, and developing similar procedures in arbitration would be duplicative and wasteful).

54 SEC Order Approving Proposed Rule Change Relating to the Exclusion of Class Actions From Arbitration Proceedings, *supra* note 53, at *9–10.

55 Black & Gross, *supra* note 7, at 28. In contrast to representative or class actions, since 1984 SRO rules have provided for consolidation of claims. *See Notice to Members 84-51*, *Amendments to Code of Arbitration Procedure,* 1984 NASD Lexis 330, at *9 (Sept. 28, 1984), now embodied in FINRA 12312, which vests the Director and arbitration panel with the authority to separate or consolidate claims against in a single arbitration proceeding under certain circumstances, *see infra* notes 71, 86–90 and accompanying discussion. As the *Schwab* Panel stated in its decision, consolidation of claims under FINRA Rule 12312 is triggered when a matter is otherwise subject to arbitration, and is not a representative type of procedure, distinguished from class actions. *Schwab*, 2013 WL 1463100 at *8.

56 AT&T Mobility, LLC v. Concepcion, 131 S. Ct. 1740 (2011).

tion alleging fraud and false advertising in connection to the carrier's "free cell phone" promotion.[57] AT&T moved to compel arbitration, pointing to the mandatory arbitration agreement in its cell phone service contract with its customers that prohibited class actions.[58] The District Court denied AT&T's motion based on California's *Discover Bank* rule,[59] holding that the mandatory arbitration provision was unconscionable because AT&T had failed to demonstrate that the provision "adequately substituted for the deterrent effects of class actions."[60] The Ninth Circuit affirmed, also finding the provision unconscionable and, further, holding that the *Discover Bank* rule was not preempted by the FAA because it was "'a refinement of the unconscionability analysis applicable to contracts generally in California.'"[61]

In a 5-4 decision, the Supreme Court reversed, holding that the FAA preempted state law that operated to invalidate a contractual arbitration provision. Writing for the majority, Justice Scalia started with the Court's now standard reiteration of the origins and purpose of the FAA, specifically that it was enacted in 1925 in response to "widespread judicial hostility" to arbitration agreements,[62] and that the FAA reflects "both a 'liberal federal policy favoring arbitration' . . . and 'the fundamental principle that arbi-

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57 *Id*. at 1744. AT&T Mobility had advertised free telephones when a customer entered into a new service contract. *Id.* The Concepcions entered into the cell phone service contract with AT&T and received cell phones, but had to pay $30.22 in sales taxes based on the retail value of the phones. *Id.* Plaintiffs filed an action in U.S. District Court, which was later consolidated with a putative class action. *Id*. at 1744–45.

58 *Id.*

59 In Discover Bank v. Superior Court, 113 P.3d 1100 (Cal. 2005), the California Supreme Court held that class action waivers in arbitration agreements may be held unconscionable and, therefore, unenforceable, under certain circumstances. *Concepcion*, 131 S. Ct. at 1746 (citing *Discover Bank*, 113 P.3d at 1110). Specifically, when the waiver is found in a "consumer contract of adhesion," where the disputes involve "predictably small amounts of damages," and the party with the "superior bargaining power" has engaged in wrongful conduct that serves to "cheat large numbers of consumers out of individually small amounts of money," and enforcement of the provision would "exempt" the party from responsibility, presumably because it would be too costly to bring individual claims, the *Discover Bank* rule allows California courts to invalidate and refuse to enforce such provisions. *Id.* (quoting *Discover Bank*).

60 *Concepcion*, 131 S. Ct. at 1745 (citing Laster v. T-Mobile USA, Inc., No. 05cv1167 DMS (AJB), 2008 WL 5216255, *14 (S.D. Cal., Aug. 11, 2008)). Although the District Court found that the arbitration provision in AT&T's cell phone service contract unconscionable on this ground, it did describe the provision favorably, noting that it provided customers with a "'quick, easy to use'" dispute resolution process and a minimum recovery provision for the customer. *Id*.

61 *Id.* (quoting Laster v. AT&T Mobility, LLC, 584 F.3d 849, 855 (9th Cir. 2009)).

62 *Id.* at 1745 (citing Hall St. Assocs., LLC v. Mattel, Inc., 552 U.S. 576, 581 (2008)).

tration is a matter of contract.'"[63] Observing that the *Discover Bank* rule had been routinely applied by California courts to invalidate arbitration agreements in adhesion contracts, it held that the rule "'stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress'" and was, therefore, preempted by the FAA.[64]

Concepcion is widely regarded as having dealt a near fatal blow to judicial class actions brought on behalf of consumers, civil rights plaintiffs and others.[65] In the first year after *Concepcion*, forty-five class actions were dismissed by federal courts on the grounds that the claims were subject to a mandatory arbitration provisions.[66] In the context of securities claims, however, customers' abilities to bring or participate in class actions had not been impacted by *Concepcion* because its members did not challenge

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63 *Id.* (quoting Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983) and Rent-A-Center, West, Inc. v. Jackson, 130 S. Ct. 2772, 2776 (2010)).

64 *Id.* at 1753 (quoting Hines v. Davidowitz, 312 U.S. 52, 67 (1941)).

65 *See generally* Miriam Gilles & Gary Friedman, *After Class: Aggregate Litigation in the Wake of* AT&T Mobility v. Concepcion, 79 U. CHI. L. REV. 623, 627 (2012) (*Concepcion* all but forecloses aggregate litigation for consumers, civil rights plaintiffs, and others because companies can essentially insulate themselves with waiver provisions that will be upheld.); Jill I. Gross, *AT&T Mobility and the Future of Small Claims Arbitration*, 42 SW. U. L. REV. 47, 49 (2012) ("By inserting a class action waiver clause in their consumer contracts, companies can prevent consumers from aggregating small claims, forcing them to pursue small claims individually. . . . The funneling of low dollar value claims into simplified arbitration has serious implications for consumers and most investors of modest means seeking substantive and procedural justice in a forum in which their claim is heard solely on the papers. Substantively, *pro se* parties may not have the education, training, or ability to effectively communicate their complex arguments in writing.") (citations omitted); Sarah Rudolph Cole, *On Babies and Bathwater: The Arbitration Fairness Act and the Supreme Court's Recent Arbitration Jurisprudence*, 48 HOUS. L. REV. 457, 462–63 (2011) ("[T]he most pressing issue in consumer arbitration, in the wake of recent Supreme Court decisions, is the lack of a viable forum for consumers with low value claims."); Jean R. Sternlight, *Tsunami:* AT&T LLC v. Concepcion *Impedes Access to Justice*, 90 OR. L. REV. 703, 704 (2012) ("It is highly ironic but no less distressing that a case with a name 'conception' should come to signify *death for the legal claims of many potential plaintiffs*. . . . By permitting companies to use arbitration clauses to exempt themselves from class actions, *Concepcion* will provide companies with free rein to commit fraud, torts, discrimination and other harmful acts without fear of being sued.") (emphasis added).

66 Robert M. Buchanan, Jr., *The U.S. Supreme Court's Landmark Decision in* AT&T Mobility v. Concepcion*: One Year Later,* BLOOMBERG LAW (2012), *available at* http://about.bloomberglaw.com/practitioner-contributions/att-v-concepcion-one-year-later/. The author identified seventy-six cases from the date *Concepcion* was issued in April 2011, through March 2012, where federal courts reviewed an arbitration provision in a putative class action, and found: 1) in forty-five cases the courts enforced the arbitration provisions and dismissed the cases; 2) in fourteen cases the courts rejected the arbitration provision and maintained the class action; 3) in four cases the plaintiffs brought their class actions in arbitration, and 4) in thirteen cases the federal courts had not decided the issue but rather, either sent the issue to arbitration for resolution by the arbitration panel, or ordered further discovery or set an evidentiary hearing. *Id.*

FINRA's conduct rules prohibiting class action waivers. Until Schwab decided to take on the challenge.

B. *Emboldened By Concepcion, Schwab Amends Nearly Seven Million Customer Agreements to Include a Class Action Waiver Provision and Non-Consolidation Agreement*

In October 2011, on the heels of the *Concepcion* decision, Schwab amended its Customer Account Agreement to include a provision titled, "Waiver of Class Action or Representative Action" ("Waiver").[67] The new provision was contained in a forty-page document Schwab mailed to its 6.8 million customers titled "Important account information you need to know," containing a series of amendments to the customers' account agreements with Schwab.[68] The Waiver stated in relevant part:

> Neither you nor Schwab shall be entitled to arbitrate any claims as a class action or representative action, and the arbitrator(s) shall have no authority to consolidate one or more than one parties' [sic] claims or to proceed on a representative or class action basis. 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.

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.

[67] Dep't of Enforcement v. Charles Schwab & Co., Disciplinary Proceeding No. 2011029760201, 2013 WL 1463100 at *10. Schwab had also recently settled two class actions alleging, among other things, that Schwab misled investors about the risks associated with its proprietary Yield Plus Funds, in violation of federal and state securities laws. *In re* Charles Schwab Sec. Litig., No. C08-01510 WHA, 2011 WL 1481424 (N.D. Cal. Apr. 19, 2011) (order approving class action settlements totaling $235,000,000). The Schwab Yield Plus class action litigation demonstrates the importance of a collective action procedure for small claims: the average estimated settlement payment was $881, *id.* at *17–18, an amount too small to make arbitration on an individual basis feasible. *See also* Black & Gross, *supra* note 7, at 7.

[68] *Schwab*, 2013 WL 1463100 at *9–10, n.41. The forty-page notice to customers contained five amendments to their customer account agreement, including the Waiver at issue, which was one of five amendments. *Id.* at *10 n.41.

On February 1, 2012, FINRA Enforcement brought an action for sanctions against Schwab, alleging that the Waiver provision violated FINRA Rule 2268(d)(1) and NASD Rule 3110(f)(4)(A), which prohibit member firms from including "any condition" in PDAAs that "limits or contradicts the rules of any self-regulatory organization," and FINRA Rule 2268(d)(3) and NASD Rule 3110(f)(4)(C), which expressly prohibit member firms from including "any condition" in PDAAs that "limits the ability of a party to file any claim in court permitted to be filed in court under the rules of the forums in which a claim may be filed under the agreement."[69] Enforcement argued that the prohibition against judicial class actions expressly "limits" and "contradicts" a customer's rights under FINRA Rule 12204(d) of the Customer Code.[70] Enforcement further alleged that the Waiver's non-consolidation language that "the arbitrator(s) shall have no authority to consolidate one or more than one parties' [sic] claims" violated FINRA Rule 12312 of the Customer Code.[71] Finally, by virtue of these rule violations, Enforcement alleged that Schwab violated FINRA Rule 2010, *Standards of Commercial Honor and Principles of Trade*.[72]

Importantly, Enforcement argued that the FAA was irrelevant because the only issue before the Panel was whether the Waiver violated FINRA's member conduct rules and, if so, sanctions should be imposed.[73] However, Schwab argued that even if it vio-

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69 Although FINRA's procedural rules were applicable at the time the enforcement action was filed, the applicable conduct rules that were alleged to have been violated are those that existed at the time the conduct occurred. *Id.* at *2 n.1. NASD Rules 3110(f)(4)(C) and (f)(4)(A) were effective until December 4, 2011, and thus applicable when Schwab introduced its Waiver. FINRA Rules 2268(d)(3) and 2268(d)(1), which contain the same language as NASD Rules 3110(f)(4)(C) and (f)(4)(A), respectively, became effective on December 5, 2011.

70 *Schwab*, 2013 WL 1463100 at *3–4. FINRA Rule 12204, *Class Action Claims*, was in effect throughout the relevant period. *Id.*

71 *Id.* at *4. FINRA Rule 12312 was in effect throughout the relevant period. *Id.* Rule 12312(a) allows one or more parties in an arbitration proceeding to submit multiple claims jointly if they contain "common questions of law or fact" and either "assert any right to relief jointly and severally," or the "claims arise out of the same transaction or occurrence, or series of transactions or occurrences." FINRA Rule 12312(a). Subsection (b) of the rule grants the Director of Arbitration the power to separate claims filed jointly, or initiate consolidation of claims, prior to the appointment of the panel of arbitrators. Once the panel is appointed, however, Rule 12312 provides final authority on consolidation to the arbitrators. FINRA Rule 12312(b).

Enforcement argued that Schwab's imposition of an agreement to limit the power of the arbitrators to consolidate multiple claims was an impermissible "limit" or "contradiction" of Rule 12312, in violation of FINRA Rule 2268(d)(1) and NASD Rule 3110(f)(4)(A). *Schwab OHO Decision, supra* note 18, at *5.

72 *Schwab* Complaint & Request for Expedited Hearing, *supra* note 16, at ¶¶ 20, 26, 32.

73 *Schwab*, 2013 WL 1463100 at *5.

lated FINRA's conduct rules, the FAA applied and prevented the enforcement of those Rules.[74] Schwab successfully persuaded the Panel that the FAA applied and, under the Supreme Court's decision in *Concepcion*, FINRA's rules preventing waiver of judicial class actions were unenforceable.[75]

C. *The FINRA Hearing Panel Refuses to Enforce its Member Conduct Rules Prohibiting Class Action Waivers*

Reviewing both the plain terms and purpose of the relevant conduct rules, the Panel easily reached the conclusion that Schwab violated rules as alleged, observing that since 1989, the NASD and other SROs have prohibited its members from limiting or contradicting its arbitration rules in order to ensure that "investor disputes with broker-dealers are handled in a consistent fashion, according to the rules that have been reviewed and approved by the [SEC] as contributing to investor protection and the public interest."[76] The Panel further found that Rule 12204 was "intended and designed to preserve judicial class actions as an option" and, when read together with FINRA Rules 2268(d)(1) and (d)(3), these rules operate to preserve a customer's right to pursue a judicial class action and prohibit a member from otherwise limiting that right.[77]

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74 *Id.* On the same day that FINRA filed its enforcement proceeding, Schwab filed an action in District Court for the Northern District of California seeking a declaratory judgment and preliminary injunction prohibiting FINRA from proceeding with the enforcement action. Charles Schwab & Co. v. FINRA, 861 F. Supp. 2d 1063 (N.D. Cal. 2012). On May 12, 2012 the magistrate judge dismissed Schwab's action on the grounds that it failed to exhaust its administrative remedies. *Id.* at 1069.

75 *See infra* notes 79–85 and accompanying discussion. The Hearing Panel held a non-evidentiary hearing on May 30, 2012 and, thereafter, on Aug. 28, 2012, issued an Order informing the parties that the panel had determined to dismiss the first two Causes of Action (based on the waiver of the judicial class action), but to find a violation as to the third Cause of Action (based on the prohibition against consolidation of claims in arbitration). The Hearing Panel ordered briefs on sanctions. *Schwab*, 2013 WL 1463100 at *3.

76 *Schwab*, 2013 WL 1463100 at *10–11.

77 *Id.* at *11–12. "[F]or two decades, the industry has understood these Rules to operate together to preserve customer's ability to bring or participate in judicial class actions." *Id.* (citing Notice To Members ("NTM") 92–65, 1992 NASD LEXIS 23 (Dec. 1992)). NASD's Notice to Members informed its members that they could not use a PDAA to limit a customer's right to participate in a class action. *Id*. at *12. The Panel also pointed to the *absence* of class action waivers in PDAAs until Schwab inserted its provision post-*Concepcion* as further evidence of the industry's understanding that such waivers are prohibited by SRO rules. *Id*.

Finding that Schwab clearly violated FINRA's conduct rules, the Panel should have ended its inquiry and sanctioned Schwab.[78] Instead, shifting its focus with little explanation from Schwab's conduct and its obligations under its membership agreement with FINRA, to Schwab's agreement with its customers, the Panel set out to determine whether the FAA applied to the Waiver provision.[79] By focusing entirely on Schwab's agreement with its customers, the Panel judged the enforceability of that agreement under the FAA (which it held applied to Schwab's agreement)[80] and a long line of Supreme Court cases interpreting the FAA as establishing a "national policy of arbitration."[81]

According to the Panel, *Concepcion* and subsequent Supreme Court cases required enforcement of the Schwab Waiver provision unless there was a clear "contrary congressional command," reasoning that "countervailing policy concerns that might counsel against arbitration of a particular kind of dispute—whether state or federal, statutory or regulatory—cannot override the FAA's mandate, unless there is a clear expression of *congressional* intent to carve out an exception to the FAA."[82] The Panel acknowledged,

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78 Indeed, the only relevant agreement before the Panel was the member agreement between FINRA and Schwab, not the customer agreement. *See infra* notes 95–105 and accompanying discussion. Moreover, the Panel does not have authority to refuse to enforce FINRA rules. *See infra* notes 106–112 and accompanying discussion.

79 *Schwab*, 2013 WL 1463100 at *16 .

80 *Id*. The Panel reasoned that Section 2 of the FAA applies to "every written agreement to arbitrate" in a contract "'evidencing a transaction involving commerce,'" such as that in Schwab's customer agreement, and Schwab's customer agreement expressly incorporates the FAA. *Id*. The Panel also observed that FINRA has not objected to the inclusion and application of the FAA in its members' agreements with customers. *Id.*

81 *Id.* at *17 (quoting AT&T Mobility, LLC v. Concepcion, 131 S. Ct. 1740, 1747 (2011)). The Panel explained that in *Concepcion,* the Supreme Court rejected the judicially created public policy doctrine under *Discover Bank* that provided exceptions to enforcement of class action waivers where application would be unconscionable because of the size of the claim, and made plain that no state policy could supersede the FAA's arbitration mandate. *Id.* at *17.

82 *Id.* (quoting Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 226 (1987)). The Panel discussed four subsequent Supreme Court cases since *Concepcion* that, it reasoned, further supported that notion that claims subject to an arbitration agreement must be arbitrated under the FAA unless there is a clear congressional command to the contrary. *Id.* at *17–18. Three of the decisions involved state law: Nitro-Lift Technologies, LLC. v. Howard, 133 S. Ct. 500, 503 (2012) (per curiam) (vacated an Oklahoma court decision holding non-compete agreements unenforceable under Oklahoma law on the grounds that the agreement contained mandatory arbitration provision); Marmet Health Care Ctr. v. Brown, 132 S. Ct. 1201, 1203 (2012) (arbitration provision in nursing home contract must be enforced despite West Virginia's public policy holding such agreements unenforceable); KPMG LLP v. Cocchi, 132 S. Ct. 23, 25 (2011) (per curiam) (vacated and remanded Florida state court decision refusing to compel arbitration of two claims because other claims were not subject to arbitration and the result would be proceedings in two forums); Compucredit Corp. v. Greenwood, 132 S. Ct. 665, 669 (Jan. 10,

and quickly dismissed, the SEC's general oversight of FINRA's authority to promulgate rules as insufficient to establish a contrary congressional command to create an exception to the FAA.[83] Looking no further and noting that Enforcement had failed to identify anything in the securities laws showing a "congressional intent to preserve judicial class actions as an option" in customer claims,[84] the Panel concluded that Schwab's Waiver must be enforced "to require customers to go to arbitration and that any FINRA policy determination that judicial class actions should remain available to customers must give way to the FAA's mandate."[85]

The Panel reached the opposite conclusion with respect to Schwab's Waiver provision under which customers agreed that "the arbitrator(s) shall have no authority to consolidate one or more than one parties' [sic] claims."[86] The Panel agreed that Schwab's Waiver provision prohibiting consolidation of claims did violate FINRA rules because it deprives arbitrators of authority expressly granted under FINRA Rule 12312 under the Customer Code.[87] It

2012) (involved a federal statutory claim under the Credit Repair Organizations Act ("CROA")). In *Compucredit*, the Court vacated and reversed a Ninth Circuit order refusing to compel arbitration of CROA claims brought by consumers in a class action against credit card marketer and banks. *Compucredit*, 132 S. Ct. at 669. The Panel pointed to *Compucredit* in support of its conclusion that the analysis under the FAA is the same whether the countervailing policy is state, federal or regulatory. *Schwab*, 2013 WL 1463100 at *18–19.

83 *Schwab*, 2013 WL 1463100 at *18–19. Although the Panel acknowledged that FINRA promulgates rules pursuant to delegated authority from the SEC and that its rules are subject to oversight and approval, and may preempt state law, it reasoned that those rules can only be enforced to the extent they are consistent with federal law—which includes the FAA. *Id*.

This conclusion wholly ignores the highly structured and regulated system created by the Exchange Act and subsequent amendments, with the primary goals of promoting market efficiency and integrity, and investor protection. Under Section 15A of the Exchange Act, 15 U.S.C. § 78o-3, Congress gave "front-line authority for regulating" the brokerage industry to SROs, under direct oversight of the SEC. Black & Gross, *supra* note 7, at 17. As Professors Black and Gross explain, "FINRA's *raison d'etre* is to carry out the statutory purposes and to enforce compliance by its members and associated persons with the provisions of the Exchange Act and its regulations as well as FINRA's own rules." *Id.* at 17–18. The SEC's direct oversight of FINRA's rulemaking process, including rules governing its dispute resolution forum, provide a compelling evidence of a Congressional intent to preserve the ability FINRA to bar class action waiver provisions in the PDAAs of its members.

84 *Schwab*, 2013 WL 1463100 at *19.

85 *Id.*

86 *Id.*

87 *Id.* at *19–20. The Panel observed that "NASD arbitrators first were granted express authority to consolidate or join claims in 1984, and NYSE arbitrators gained such express authority in 1990. Although the precise language of the Rules has changed over time, it has been plain for decades that arbitrators have the power to make all final determinations with respect to joining and consolidating the claims of multiple parties." *Id.* at *13.

found that the FAA was not implicated, however, because consolidation is a "procedural issue" that is triggered once the matter has been submitted to arbitration in the first place.[88] "Once it is clear that a particular dispute falls within the scope of an arbitration agreement, procedural questions regarding how the arbitration should proceed are determined by the arbitrators."[89] The Panel concluded that Schwab's non-consolidation provision in the Waiver provision violated FINRA's Rules and sanctioned Schwab with a fine of $500,000.[90]

IV. Why FINRA Prohibitions On Judicial Class Action Waivers Do Not Violate the FAA

Only several months after the *Schwab OHO* decision, the Supreme Court reinforced its jurisprudential approach of elevating the FAA to super contract status, while further closing the door to

[88] *Id.* at *20. The Panel also noted the difference between consolidation of claims and class actions:

> [C]onsolidation—in contrast to class action procedure—is consistent with the goals of the FAA, because consolidation concerns considerations of efficiency and streamlined resolution of similar issues. Consolidation—unlike class action procedure—does not involve complex issues of notice and fairness to absent parties . . . The ability of the forum to consolidate when appropriate and to clarify in a consistent way the applicable law contributes to FINRA's ability to perform its regulatory mission and protect investors." *Id.* (quotation and citations omitted).

[89] *Id.* at *17 (citing Dockser v. Schwartzberg, 433 F.3d 421, 426–27 (4th Cir. 2006)). The Panel reasoned that the FAA does not specify what powers an arbitrator should have or the particular procedures that must be followed in arbitration, nor does the FAA prohibit FINRA from authorizing an arbitrator the right to consolidate multiple claims or from barring members from altering procedures in arbitration. *Id.* at *17–18. Ironically, the Panel pointed to the "highly regulated nature of the securities industry" and, specifically, to the 1975 amendments to the Exchange Act to support the notion of a structured and consistent approach to arbitration procedures that should be uniformly applied to members: "To permit FINRA members like Schwab to write themselves out of FINRA's Rules would undercut the basis for the decision in [*Shearson/Am. Express v. McMahon*] that arbitration does not deprive customers of substantive protections under the securities laws." *Id.* at *20 (citing Shearson/Am. Express v. McMahon, 482 U.S. 220, 233–34 (1987)). This analysis undermines the Panel's reasoning with respect to Schwab's judicial class action waiver provision.

[90] *Schwab*, 2013 WL 1463100. at *21–22. FINRA Enforcement has appealed the Panel's decision to the NAC. On May 15, 2013, Schwab announced that it was modifying its customer account agreement to eliminate the class action waiver provision for any disputes relating to events occurring after that date and for the foreseeable future. Press Release, *Schwab Statement on Class Action Waivers*, Charles Schwab (May 15, 2013), *available at* http://www.aboutschwab.com/press/issues/statement. Schwab stated that while it believed that the arbitral forum was best suited to resolve disputes, it would "voluntarily remove the waiver going forward until the issue is resolved by the appropriate regulatory and/or court decisions." *Id.*

class actions of small claims otherwise subject to arbitration. First, in *Oxford Health Plans v. Sutter*,[91] the Court upheld an arbitrator's construction of the parties' agreement as providing for class arbitration.[92] Second, and only ten days after *Oxford Health Plans* was decided, the Court issued *Italian Colors*,[93] a decision that essentially eliminates the "effective vindication" exception to enforcement of judicial class action waivers in most PDAAs.[94] However, fundamental differences between arbitration of customer securities disputes and arbitration of consumer or employment disputes require the NAC to reverse the Panel decision. Moreover, the Exchange Act and recent amendments under Dodd-Frank provide "clear congressional intent" to preserve judicial class actions in securities claims against brokerage firms.

A. *The Relevant Agreement Before the Hearing Panel was the Member Agreement between FINRA and Schwab and Enforcement of that Agreement is Consistent with the FAA*

The Panel's conclusion that it could not enforce FINRA's conduct rules proscribing Schwab's judicial class action waiver under the FAA is fundamentally flawed because, among other things, it focused its analysis on the wrong agreement. Specifically, the Panel focused on Schwab's judicial waiver provision in its *customer agreement* and whether that provision was enforceable under the FAA and *Concepcion*.[95] However, in contrast to *Concepcion* and the other Supreme Court cases cited by the Panel in reaching its conclusion, one of the parties to that agreement—the customer—was not present. Indeed, procedurally the *Schwab* case was distinguishable from every Supreme Court case cited by the Panel because no customer had actually challenged the enforceability of Schwab's judicial waiver provision.[96]

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[91] 133 S. Ct. 2064 (June 10, 2013).

[92] *Id.* at 2070–71. The Court found that the parties' agreement provided that the arbitrator could decide whether the PDAA in the plaintiff physician's contract with Oxford allowed for class arbitrations. *Id.* at 2070.

[93] 133 S. Ct. 2304 (2013).

[94] *See infra* notes 131–144 and accompanying discussion.

[95] *Id.* at 15 (discussing Schwab's customer agreement and its express incorporation of the FAA in that agreement).

[96] In *Concepcion*, the arbitration agreement between AT&T and its customers was directly at issue because it was the grounds upon which AT&T moved to dismiss the class action filed by

Instead, the relevant agreement before the Panel was the one that exists between FINRA and its member, Schwab. FINRA brought an enforcement proceeding because Schwab had violated its conduct rules, which are incorporated into the member agreement between FINRA and Schwab.[97] Indeed, the membership agreement between FINRA and its members is itself an agreement to arbitrate (and enforceable according to its terms) because, among other things, it *compels* its members to consent to arbitration upon the demand of its customers, even without a separate PDAA in the agreement between the member and the customer.[98] By entering into its membership agreement with FINRA, Schwab agreed to abide by the arbitration rules of that forum, including the rules proscribing judicial class action waivers. Ignoring the membership agreement in the context of considering Schwab's waiver provision is contrary to well established Supreme Court precedent

its customers. AT&T Mobility, LLC v. Concepcion, 131 S. Ct. 1740 (2011). Similarly, all of the post-*Concepcion* decisions cited by the Panel involved disputes between parties to the agreement containing the pre-dispute arbitration provisions challenged therein: Nitro-Lift Technologies, LLC. v. Howard, 133 S. Ct. 500, 503 (2012) (employees resisted arbitration under a non-compete agreement with its former employer); Marmet Health Care Ctr. v. Brown, 132 S. Ct. 1201 (2012) (family members of nursing home relatives who executed contracts with nursing homes that contained PDAAs); KPMG LLP v. Cocchi, 132 S. Ct. 23 (2011) (auditor moved to compel arbitration in suit brought by nineteen individuals and entities who purchased limited partnerships); Compucredit Corp. v. Greenwood, 132 S. Ct. 665 (2012) (consumers subject to mandatory arbitration under PDAA contained in credit card application opposed motion to compel arbitration filed credit card marketer and banks in class action).

97 FINRA membership constitutes an agreement to "'adhere to FINRA's rules and regulations, including its Code and relevant arbitration provisions contained therein.'" *In re* Am. Express Fin. Advisors Sec. Litig., 672 F.3d 113, 128 (2d Cir. 2011) (quoting UBS Fin. Servs. v. West Va. Univ. Hosp., Inc., 660 F.d 643, 649 (2d Cir. 2011)). *See also* Kidder, Peabody & Co. v. Zinsmeyer Trusts P'shp, 41 F.3d 861, 863 (2d Cir. 1994) ("The rules of a securities exchange are contractual in nature."); Drexel Burnham Lambert, Inc. v. Pyles, 701 F. Supp. 217, 220 (N.D. Ga. 1988) ("Securities exchange members are contractually bound by the regulations of their organizations, including any arbitration provisions."). Schwab has been a member of FINRA (and NASD before it) since 1970; in its membership application with FINRA (then NASD) and subsequent amendments to that application, Schwab agreed to abide by FINRA's rules. *Schwab* Complaint & Request for Expedited Hearing, *supra* note 16, at ¶¶ 10, 11.

98 FINRA Rule 12200 of the Customer Code provides that "[p]arties must arbitrate a dispute under the Code if . . . [arbitration] . . . is [r]equested by the customer . . ." and the dispute is between a customer and member or associated person of a member and the dispute arises out of the business activities of the member. The Panel expressly recognized this in its decision, noting that FINRA's arbitration rules "themselves constitute an agreement to arbitrate that is covered by the FAA, even separate from a customer-member agreement." FINRA Office of Hearing Officers, Dep't of Enforcement v. Charles Schwab & Co., Disciplinary Proceeding No. 2011029760201, 2013 WL 1463100 at *15 (citing Washington Square Sec., Inc. v. Aune, 385 F.3d 432, 435 (4th Cir. 2004) and Morgan Keegan & Co. v. Silverman, No. 12-1208, 2013 U.S. App. LEXIS 2412, *3–4 (4th Cir. Feb. 4, 2013)).

establishing that arbitration agreements are fundamentally a matter of contract.[99]

Indeed, in *Stolt-Nielsen*, the Court stressed that arbitration "is a matter of consent, not coercion,"[100] and the primary purpose of the FAA is "to ensure that 'private agreements to arbitrate are enforced according to their terms.'"[101] Of particular relevance here is the Court's recognition that parties to an arbitration agreement may structure their contract as they choose, and enforcement of such limitations is perfectly consistent with the FAA:

> Underscoring the consensual nature of private dispute resolution, we have held that parties are 'generally free to structure their arbitration agreements as they see fit.' For example, we

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99 *Concepcion*, 131 S. Ct. at 1745 (citing Rent A Center, West, Inc. v. Jackson, 130 S. Ct. 2772, 2776 (2010)). The Supreme Court has held that a party may contractually modify or limit its ability to arbitrate by entering into other agreements, and enforcement of these agreements is entirely consistent with the FAA, even if the result is to place the particular claim or dispute outside of arbitration. *See, e.g.,* Volt Info. Scis., Inc. v. Bd. Of Trs. of Leland Stanford Junior Univ., 489 U.S. 468 (1989), where the Supreme Court held that the parties' agreement, which contained both a PDAA and a choice-of-law provision, would be enforced according to its terms even if applying the choice-of-law provision required a stay arbitration. *Id.* at 479. The Supreme Court explained that:

> [W]e have recognized that the FAA does not require parties to arbitrate when they have not agreed to do so. . . . It simply requires courts to enforce privately negotiated agreements to arbitrate, like other contracts, in accordance with their terms." *Id.* at 478–79.

Most recently, in Oxford Health Plans, LLC v. Sutter, 133 S. Ct. 2064, WL 2459522, at *1 (June 10, 2013), the Court again stressed the fundamental principle under the FAA of providing for arbitration in accordance with the parties' agreement. Sutter, a physician who provided medical services to Oxford Health Plans' insureds under a fee-for-service contract that contained an arbitration agreement filed a class action in New Jersey Superior Court alleging that Oxford had failed to fully pay him and other similarly situated physicians. *Id.* at *3. Oxford successfully moved to compel arbitration and the parties agreed that the arbitrator should decide whether the parties' PDAA authorized class arbitration. *Id.* at *3–4. The arbitrator decided that the PDAA authorized a class arbitration and, thereafter, Oxford filed a motion in federal district court to vacate the decision claiming that the arbitrator had exceeded his powers under §10(a)(4) of the FAA. *Id.* at *4. The district court denied the motion and the Court of Appeals for the Third Circuit affirmed. *Id.*

Writing for a unanimous Court, Justice Kagan stressed that the only relevant question under §10(a)(4) is whether the parties' contract provided the arbitrator with the power to decide the particular question at issue, not "whether he got its meaning right or wrong." *Id.* at *45. The Court distinguished *Stolt-Nielsen*, where the arbitrator lacked any contractual basis for ordering class procedures, from the case at bar where the parties agreed to give the arbitrator the power to interpret the broad arbitration provision in Oxford's contract. *Id.* at * 6. Notwithstanding the *Concepcion* majority's reservations about the use of class procedures in arbitration, *Concepcion*, 131 S. Ct. at 1750–51, the Court upheld the arbitrator's construction of the agreement to provide for class arbitration, concluding that "[t]he arbitrator's construction holds, however good, bad or ugly." *Id.*

100 Stolt-Nielsen v. Animalfeeds Int'l Corp., 130 S. Ct. 1758 at 1773 (quoting *Volt*, 489 U.S. at 479).

101 *Id.* (quoting *Volt*, 489 U.S. at 478).

> have held that parties may agree to limit the issues they choose to arbitrate, and may agree on rules under which any arbitration will proceed. . . . They may choose who will resolve specific disputes. . . . We think it is also clear from our precedents and the contractual nature of arbitration that parties may specify *with whom* they choose to arbitrate their disputes.[102]

Through its membership agreement with FINRA, which is entirely voluntary, Schwab agreed to limit by contract its ability to arbitrate and abide by the arbitration procedures mandated by FINRA. Schwab agreed to abide by FINRA requirements concerning the use of PDAAs, including FINRA Rule 2268, which prohibits placing limitations on these agreements.[103] In return, Schwab is reaping the benefits of its membership agreement with FINRA by conducting a securities business in the U.S. It would be inimical to the principles of contract and the FAA to not enforce all of these provisions, including the limitation on the content of Schwab's arbitration provisions with its customers.[104]

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102 *Id.* at 1774 (quotations and citations omitted).

103 As noted by Professors Black and Gross, courts have voided securities firms' arbitration provisions that run afoul of SRO rules. Black & Gross, *supra* note 7, at n.154 (citations omitted).

104 The Panel's analysis was also flawed to the extent that it equated FINRA's rules to federal regulation: "While [FINRA] Rules have the force and effect of federal regulation and may preempt state law, FINRA's Rules can only be enforced to the extent that they are not inconsistent with federal law." FINRA Office of Hearing Officers, Dep't of Enforcement v. Charles Schwab & Co., Disciplinary Proceeding No. 2011029760201, 2013 WL 1463100 at *18 (citing Credit Suisse First Boston v. Grunwald, 400 F.3d 1119, 1128–32 (9th Cir. 2005); Clark v. Wells Fargo Invs., LLC, No. 10-4916 SC, 2011 U.S. Dist. LEXIS 79975, at *5–7 (N.D. Cal July 22, 2011); Heilimann v. Bank of Am. Corp., No. CV 10-8623-GW(JCx), 2011 U.S. Dist. LEXIS 68155, at *4 (C.D. Cal., June 6, 2011); Bloemendaal v. Morgan Stanley Smith Barney LLC, EDCV 10-1455 DSF (PLAx), 2011 U.S. Dist. LEXIS 61772, at *22–23 (C.D. Cal., May 23, 2011)). These cases, however, cannot be stretched to the conclusion urged by the Panel. *Grunwald* involved a conflict between new California state rules and NASD rules governing arbitrator disclosures; the Ninth Circuit held that state rules that conflict with SRO rules are preempted under the Exchange Act if they prevent the SRO from complying with its rules (which have been approved by the SEC) or if it "interferes with the Congressional goals underlying the Exchange Act." *Grunwald,* 400 F.3d at 1132. The remaining cases involved challenges to brokerage firms' employee account and trading policies, promulgated under NYSE Rule 407, among other SRO rules. Relying on *Grunwald*, among other cases, and discussing generally the system created by the Exchange Act of self-regulation by SROs under SEC oversight, the district courts held that the SRO rules preempted various actions under state law. *Clark*, 2011 U.S. Dist. LEXIS 79975 at *5–7 (NYSE Rule 407 preempts action under Section 450 of the California Labor Code); *Heilimann*, 2011 U.S. Dist LEXIS 68155, *6–7 (same); *Bloemendaal*, 2011 U.S. Dist. LEXIS 61772, at *24–26 (same).

As the Ninth Circuit recognized in *Grunwald*, even though the SEC has direct oversight of FINRA and its rulemaking process, FINRA is a private organization. *Grunwald,* 400 F.3d at 1128 (SROs are "private entities"); *see also* Bank of Am., N.A. v. UMB Fin. Servs., 618 F.3d 906, 909 (8th Cir. 2010) ("FINRA is a private entity"); Waddell & Reed Fin. Inc. v. Torchmark Corp., 223 F.R.D. 566, 623 (D. Kan. 2004) ("NASD is a private, not-for-profit corporation"); Desiderio

Moreover, failing to enforce the member agreement inappropriately elevates one contract over another. The Supreme Court has repeatedly stressed that the purpose of the FAA is to place arbitration agreements on "'the same footing as other contracts,"[105] not to elevate arbitration agreements above other contracts. By focusing on the Schwab agreement with its customer (which was not directly at issue in any event), the Panel effectively elevated that agreement above the agreement that exists between FINRA and Schwab.

B. *The Hearing Panel Did Not Have the Authority to Refuse to Enforce FINRA's Conduct Rules*

Another fundamental problem with the *Schwab OHO* decision is that it ignores FINRA's statutory obligation to enforce its own rules under Section 19(h) of the Exchange Act, which states in pertinent part:

> Suspension or revocation of self-regulatory organization's registration; censure; other sanction
>
> The appropriate regulatory agency for a self-regulatory organization is authorized . . . to suspend for a period not exceeding twelve months or revoke the registration of such self-regulatory organization, or to censure or impose limitations upon the activities, functions, and operations of such self-regulatory organization, if such appropriate regulatory agency finds . . . that such self-regulatory organization has violated or is unable to comply with any provision of . . . its own rules or without reasonable

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v. NASD, 191 F.3d 198, 206 (2d Cir. 1999) ("NASD is a private actor, not a state actor."); United States v. Shvarts, 90 F. Supp. 2d 219, 222 (E.D.N.Y. 2000) ("It is beyond cavil that the NASD is not a government agency; it is a private, not-for-profit corporation.").

105 Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 219 (1985) (citing H. R. Rep. No. 96, 68th Cong. (1924)). *See also* AT&T Mobility, LLC v. Concepcion, 131 S. Ct. 1740, 1745 (2011) ("In line with these principles, courts must place arbitration agreements on an equal footing with other contracts, and enforce them according to their terms."). Notwithstanding this principle reiterated by the Court in a long line of cases through *Concepcion*, Supreme Court jurisprudence in the last thirty years has actually thwarted that purpose, establishing, instead, a judicial policy *favoring* arbitration. *See* Jodi Wilson, *How the Supreme Court Thwarted the Purpose of the Federal Arbitration Act*, 63 Case W. Res. L. Rev. 91, 94 (2012); *see also* Ronald G. Aronovsky, *The Supreme Court and the Future of Arbitration: Towards a Preemptive Federal Arbitration Procedural Paradigm?*, 42 Sw. L. Rev. 131, 134 (2012) (Court's expansive '"pro-arbitration policy' may be leading toward a preemptive federal arbitration procedural paradigm"); Gross, *supra* note 4, at 495 (observing that the Supreme Court's decisions since *McMahon* "have imbued the FAA with super status").

> justification or excuse has failed to enforce compliance . . . by a member.[106]

Section 19(h) provides the SEC with authority to sanction any SRO that has failed to comply with any provision or rule of the Exchange Act, or has "failed to enforce" compliance of the SRO's own rules.[107] The SEC has instituted administrative proceedings against the NASD and other SROs when they have failed to enforce rules under the Exchange Act or their own rules.[108]

The Panel simply did not have the authority to refuse to enforce FINRA's conduct rules. To the contrary, to the extent the Panel's refusal to enforce the relevant conduct rules amounts to a modification of those rules, it is impermissible under Section 19(b) of the Exchange Act, which requires that all rule changes, additions or deletions be filed with the SEC and subject to the approval process set forth in Section 19(b)(2).[109] Section 19(b)(1) makes plain that "[n]o proposed rule change shall take effect unless approved by the Commission or otherwise permitted in accordance with the provisions of this subsection."[110] "By declaring FINRA's conduct rules 'non-enforceable,' the Panel has *de facto* deleted the

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106 15 U.S.C. § 78a (2006).

107 *Id.* at § 78s(h)(1). *See also* Lawhead, *supra* note 8, at 222 ("FINRA must enforce compliance by its members with the Exchange Act, including Exchange Act rules, and FINRA's rules.").

108 *See, e.g.*, *In re* Nat'l Ass'n of Sec. Dealers, Inc., Exchange Act Rel. No. 37538, 62 SEC Docket 1346 (Aug. 8, 1996) ("The Exchange Act requires the NASD, as a self-regulatory organization, to comply with, and vigorously enforce, in an evenhanded and impartial manner, the provisions of the Exchange Act, the rules and regulations thereunder and its own rules, in carrying out its role as the entity responsible for the day-to-day oversight of its members and the Nasdaq market."); *see also Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding The Nasdaq Stock Market, Inc. ("Nasdaq"), as Overseen By Its Parent, The National Association of Securities Dealers, Inc. ("NASD")*, Exchange Act Rel. No. 51163 (Feb. 9, 2005), *available at* http://www.sec.gov/litigation/investreport/34-51163.htm (Finding that the NASD failed to provide sufficient oversight of Nasdaq in connection with market surveillance responsibilities delegated to it, and stressing that "the NASD, an SRO, retains overall responsibility for enforcing the federal securities laws and its own rules" even when certain functions have been delegated to another "facility" such as the Nasdaq).

109 15 U.S.C. §78s(b).

110 *Id.* at §78s(b)(1). The SEC's role in the rule-making process is critical to its regulatory oversight of SROs and Exchanges. Through a thorough review and comment process, the SEC ensures that proposed rules, and any changes or deletions to existing rules, promote fairness and efficiency in the markets and protect investors. "With only minor exceptions, no proposed rule change takes effect unless it is approved by the SEC, upon a finding that it is 'consistent' with the requirements of the Exchange Act and the applicable regulations." Black & Gross, *supra* note 7, at 18. FINRA Rules undergo at least two comment processes. First, FINRA issues a Regulatory Notice announcing proposed rules and inviting interested parties to submit comments, *see FINRA Rule Making Process, Industry Professionals FINRA*, FINRA, *available at* http://www.finra.org/Industry/Regulation/FINRARules/RulemakingProcess/ (last visited Feb. 11, 2014);

rules or, at the very least, modified them so that they carry no punishment," neither of which FINRA can do without complying with the statutory notice and comment process.[111]

While the NAC could reverse the Hearing Panel's decision on this ground alone, it leaves open the fundamental question asked by the Panel in the first place: whether there is a clear Congressional intent to create an exception from the FAA for judicial class actions in securities disputes.[112] As discussed below, the Sections 29(a) and 15(o) of the Exchange Act provide compelling evidence of a "clear congressional intent" to vest the SEC and FINRA with authority to prohibit judicial class action waivers in PDAAs between brokers and their customers.

C. *Congress Has Indicated its Intent to Preserve Judicial Class Actions for Small Claim Investors*

To the extent the Hearing Panel required explicit language in the federal securities laws establishing a "congressional intent to preserve judicial class actions as an option" in customer claims,[113] it should have found such language in two significant amendments to the Exchange Act under Dodd-Frank. Specifically, an amendment to Section 29(a),[114] which governs waivers under the Exchange Act, and Section 15(o),[115] which provides the SEC with authority to ban the use of PDAAs. Remarkably, the Panel did not mention either provision.

FINRA then submits its proposed rules to the SEC pursuant to the approval and comment process set forth in §19(b)(2). *Id.*; *see also* 15 U.S.C. §78s(b)(2).

111 Brief for the NASAA as Amicus Curiae, at 6, *In re* Dep't of Enforcement v. Charles Schwab & Co., FINRA Disciplinary Proc. No. 2011029760201, before the National Adjudicatory Counsel (Mar. 8, 2013) (on file with author).

112 FINRA Office of Hearing Officers, Dep't of Enforcement v. Charles Schwab & Co., Disciplinary Proceeding No. 2011029760201, 2013 WL 1463100 at *6, *18.

113 *Id.* at *19.

114 15 U.S.C. § 78cc.

115 15 U.S.C. § 78o(o) (amending section 15 of the Exchange Act to read, "The Commission, by rule, may prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of any broker, dealer, or municipal securities dealer to arbitrate any future dispute between them arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors.").

1. Section 29(a) of the Exchange Act

Section 29(a) of the Exchange Act prohibits "any condition, stipulation, or provision" that would bind any person to "waive compliance" with any provision of the Exchange Act or the rules promulgated thereunder.[116] The Supreme Court has interpreted this provision to be "concerned with whether [an] agreement 'weaken[s] [customers'] ability to recover under the [Exchange] Act."[117] To the extent that a class action waiver significantly affects or "weakens" a customer's ability to bring an action, it arguably runs afoul of Section 29(a), even before it was amended by Dodd-Frank.[118]

The Dodd-Frank amendment to Section 29(a), however, expressly added the reference to rules promulgated by "a self-regulatory organization."[119] Section 29(a), as amended by Dodd-Frank, now states:

> Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, *or of any rule of a self-regulatory organization*, shall be void.[120]

By expressly incorporating into Section 29(a) "any" SRO rules, which, in turn, have contained long-standing prohibitions against class action waivers in PDAAs, Congress explicitly rejected PDAAs that failed to comply with FINRA rules.[121]

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116 15 U.S.C. § 78cc.

117 Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 230 (1987) (quoting Wilko v. Swan, 346 U.S. 427, 432 (1953)). The Court concluded that Section 29(a), which voids agreements that waive "compliance" with the Exchange Act, prohibits waiver of the "substantive obligations imposed by the [Act]." *Id.* The Court reasoned that since Section 27 of the Exchange Act providing jurisdiction for violation of the Exchange Act in the district courts did not confer any substantive rights, an arbitration provision waiving the right to a judicial forum was not void under Section 29(a). *Id.*; *see also* Black & Gross, *supra* note 7, at 44.

118 Black & Gross, *supra* note 7, at 20–21. *McMahon* stands for the principle that section 29(a) "forbids agreements that weaken investors' protections under federal securities (or equivalent) laws." *Id.* at 21.

119 Pub. L. No. 111-203, § 929T, 124 Stat. 1376, 1867 (2010).

120 15 U.S.C. 78cc(a) (emphasis added).

121 15 U.S.C. 78cc(a). *See also* Black & Gross, *supra* note 7, at 19 (As a result of Dodd-Frank's amendment "[f]or the first time, § 29(a) explicitly invalidates provisions in brokerage agreements that require customers to waive compliance with FINRA rules."). Indeed, because the Schwab waiver provision effectively requires its customers to "waive compliance" with FINRA rules 2268(d) and 12204, it is rendered void under Section 29(a).

2. Section 15(o) of the Exchange Act

Dodd-Frank amended the Exchange Act to give the SEC explicit authority to prohibit the use of, or impose conditions on"

> [A]greements that require customers or clients . . . to arbitrate any future dispute between them arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors.[122]

The statute is solely an enabling statute, as it does not require the SEC to act. However, Section 15(o) provides the SEC with broad authority to prohibit or impose conditions upon the industry's use of PDAAs.[123]

Although the SEC has not yet taken any action to prohibit or limit the use of PDAAs in customer agreements, it does not need to act for purposes of the analysis at bar. The statutory authority granted by Congress alone provides evidence of a "clear congressional intent" to vest the SEC with authority to limit the use of PDAAs. For example, Dodd-Frank vested the newly created Consumer Financial Protection Bureau with authority to prohibit or limit the use of PDAAs in consumer financial products or services.[124] In *Compucredit*,[125] the Supreme Court pointed to this specific authority as an example of the "clarity" by which Congress expresses its intent to restrict the use of arbitration provisions.[126]

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122 15 U.S.C. § 78o(o).

123 Dodd-Frank's provisions are largely the result of recommendations in the Treasury Department's 2009 white paper on financial reform. DEPARTMENT OF THE TREASURY, FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION (2009) [hereinafter TREASURY REPORT], *available at* http://treasury.gov/initiatives/Documents/FinalReport_web.pdf; Barbara Black, *How to Improve Retail Investor Protection After the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 13 U. PA. J. BUS. LAW 101, 110 (2011). The Treasury Department expressed concern that the use of mandatory arbitration provisions would undermine investors' interests by eliminating access to courts. TREASURY REPORT, *supra* note 123, at 72.

124 Consumer Financial Protection Act of 2010 § 1028, 12 U.S.C. § 5518 (2012). The statute requires the Consumer Financial Protection Bureau to conduct a study on the use of mandatory arbitration agreements with consumers of financial services or products, Section 1028 (a) and, with language that is similar to that in Section 15(o) of the Exchange Act, vests the Bureau with authority to "prohibit or impose conditions or limitations on the use of an agreement between a covered person and a consumer for a consumer financial product or service providing for arbitration of any future dispute between the parties, if the Bureau finds that such a prohibition or imposition of conditions or limitations is in the public interest and for the protection of consumers." 12 U.S.C. § 5518 (b).

125 Compucredit Corp. v. Greenwood, 132 S. Ct. 665 (Jan. 10, 2012).

126 *Id.* at 672.

Given that Dodd-Frank has also vested the SEC with the same authority using nearly identical language, Section 15(o) should also provide sufficient "clarity" of congressional intent.

V. Consequences of Foreclosing Securities Class Actions and Possible Solutions

The highly regulated structure of the securities industry, with the primary goals of promoting market efficiency and investor protection, provide compelling arguments, consistent with the FAA and recent Supreme Court jurisprudence, that FINRA can prohibit members from inserting judicial class action waivers in customer agreements. Given the Supreme Court's increasing hostility to judicial class actions,[127] however, many investors with small securities claims may find themselves in the same position that individuals with small consumer, antitrust and employment claims now find themselves as a result of *Concepcion*[128] and *Italian Colors*:[129] unable to effectively pursue their claims in arbitration because the costs of doing so significantly exceed the value of those claims.[130]

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127 In addition to decisions such as AT&T Mobility, LLC v. Concepcion, 131 S. Ct. 1740 (2011), and Am. Express Co. v. Italian Colors Rest., 133 S. Ct. 2304 (2013), the Supreme Court has issued decisions in the last couple of decades that have significantly raised the bar on private plaintiffs bringing claims under the federal securities laws. *See* Carl W. Hittinger & Jarod M. Bona, *The Diminishing Role of the Private Attorney General in Antitrust and Securities Class Action Cases Aided by the Supreme Court*, 4 J. Bus. & Tech. Law 167, 175 (2009) (The Court has "limited class actions either outright or by providing lower courts with tools to dismiss the actions that are not likely meritorious."); Daniel J. Morrissey, *After the Ball is Over: Investor Remedies in the Wake of the Dot-Com Crash and Recent Corporate Scandals*, 83 Neb. L. Rev. 732, 739–42 (2005) (tracing history of Supreme Court and lower federal courts' decisions imposing restrictions on private securities litigation and class actions).

128 *Concepcion*, 131 S. Ct. 1740.

129 *Italian Colors*, 133 S. Ct. 2304

130 As the dissent in *Concepcion* recognized, "agreements that forbid the consolidation of claims can lead small-dollar claimants to abandon their claims rather than to litigate." *Concepcion*, 131 S. Ct. at 1760 (Breyer, J., dissenting) (citation omitted). *See also* Gross, *supra* note 65, at 49 ("By inserting a class action waiver clause in their consumer contracts, companies can prevent consumers from aggregating small claims, forcing them to pursue small claims individually. . . .") (internal citations omitted); Sarah Rudolph Cole, *On Babies and Bathwater: The Arbitration Fairness Act and the Supreme Court's Recent Arbitration Jurisprudence*, 48 Hous. L. Rev. 457, 462–63 (2011) ("[T]he most pressing issue in consumer arbitration, in the wake of recent Supreme Court decisions, is the lack of a viable forum for consumers with low value claims."); Jean R. Sternlight, *Tsunami:* AT&T LLC v. Concepcion *Impedes Access to Justice*, 90 Or. L. Rev. 703, 704 (2012) ("It is highly ironic but no less distressing that a case with a name 'conception' should come to signify *death for the legal claims of many potential plaintiffs*.") (emphasis added).

While *Concepcion* badly wounded the "effective vindication" doctrine, *Italian Colors* may have fired the fatal shot. The "effective vindication" doctrine was derived from language in *Mitsubishi Motors Corp. v. Soler*,[131] where the Supreme Court, in compelling arbitration of antitrust and unfair competition claims, stated that "so long as the prospective litigant may vindicate its statutory cause of action in the arbitral forum, the statute [providing the cause of action] will continue to serve both its remedial and deterrent function."[132] The Court later suggested in *Green Tree Fin. Corp.-Ala. v. Randolph*,[133] that a district court may bar enforcement of an arbitration agreement if the claimant can establish that excessive arbitration fees and costs would effectively bar claimant from "vindicating her federal statutory rights in the arbitral forum."[134] *Randolph* supported the notion that if litigants can demonstrate that the costs of pursuing their federal claims in arbitration would be prohibitively expensive, and thereby prevent them from effectively vindicating their statutory rights, a district court could refuse to enforce a PDAA.[135]

Although few federal lower courts have used this doctrine to bar enforcement of a PDAA,[136] and none have done so in the securities arbitration context,[137] it would appear that the Supreme Court's recent *Italian Colors* decision effectively shuts the door to the "effective vindication" doctrine. In reversing the Second Cir-

131 Mitsubishi Motors Corp. v. Soler Chyrsler-Plymouth, Inc., 473 U.S. 614 (1985).

132 *Id.* at 637.

133 531 U.S. 79, 90–91 (2000).

134 *Id.* at 90. Randolph, a mobile home purchaser, brought a class action against the lender that financed purchase alleging violations of the Truth in Lending Act and Equal Credit Opportunity Act. *Id.* at 82–83. The Eleventh Circuit had reversed the district court's order compelling arbitration on the grounds that the arbitration provision in the parties' lending agreement was silent as to arbitration fees and costs and, therefore, was unenforceable because it "posed a risk that [Randolph's] ability to vindicate her statutory rights would be undone by 'steep' arbitration costs." *Id.* at 84. The Court reversed, observing that the record contained no information as to the costs of arbitration and, thus, the "risk" that Randolph would be saddled with prohibitive costs was just too speculative to justify not enforcing the arbitration agreement. *Id.* at 90–91.

135 *See generally* Miriam Gilles & Gary Friedman, *After Class: Aggregate Litigation in the Wake of* AT&T Mobility v. Concepcion, 79 U. CHI. L. REV. 623, 641 (2012) ("Randolph harmonizes the FAA with substantive federal remedial statutes by mandating that 'that party bear[ ] the burden of showing the likelihood of incurring such costs'—that is, that it would incur costs so steep as to preclude vindication of the federal right.").

136 Gross, *supra* note 4, at 496. *See also* Black & Gross, *supra* note 7, at 46.

137 *Id.* at n.108 (citations omitted); *see also* Black, *supra* note 10, at 6–7 (although the Supreme Court has acknowledged that excessive arbitration fees may deny litigants access to an arbitration forum, this argument has not been effective in the context of securities arbitration, particularly where SROs have waived or deferred payment of forum filing fees on the basis of the claimant's financial condition).

cuit's decision refusing to enforce a PDAA in the context of a class action alleging antitrust violations against American Express,[138] Justice Scalia, writing for the majority, dismissed the doctrine as mere dicta and rejected the notion that the costs of pursuing individualized claims in arbitration could operate to invalidate a PDAA.[139] Reasoning that the doctrine originated from a desire to protect the *prospective* assertion of rights,[140] the Court made clear that the doctrine does not invalidate a mandatory PDAA due to costs associated with proving the claim.[141] "[T]he fact that it is not worth the expense involved in *proving* a statutory remedy does not constitute the elimination of the *right to pursue* that remedy."[142]

Italian Colors all but extinguishes any potential exception to judicial class action waivers in arbitration agreements.[143] In the context of securities arbitration, it would be difficult to imagine "administrative fees" that could meet the standard set by the Court in *Italian Colors* except in the smallest of cases.[144] Thus, as *FINRA v. Schwab* slowly makes its way through the NAC and, if reversed, the SEC and federal court, it is imperative that the SEC, FINRA, financial firms and other stakeholders in the securities industry be-

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138 *In re* Am. Express Merchs.' Litig. 667 F.3d 24 (2d Cir. 2012) (*Amex III*).

139 *A*m. Express Co. v. Italian Colors Rest. 133 S. Ct. 2304, 2311 (2013).

140 According to the majority, examples of such barriers to the potential assertion of statutory rights include an arbitration provision forbidding the assertion of certain rights of action in the first place, or an arbitral system that imposes "administrative fees" that are "so high as to make access to the forum impracticable." *Id.*

141 *Id.*

142 *Id.*

143 The Massachusetts Supreme Judicial Court reluctantly acknowledged that *Italian Colors* "invalidated" the public policy that the court had relied upon only two months prior to invalidate a PDAA in a Dell service contract with its customers on the grounds that the low value of any recovery would make it unlikely that any claims would be pursued outside of the context of a class judicial proceeding. Feeney v. Dell Inc., 454 Mass. 192, SJC-11133 (Ma. Aug. 1, 2013) (*Feeney III*). *See also* Sutherland v. Ernst & Young LLP., 2013 WL 4033844 at *5 (2d Cir. Aug. 9, 2013) (in class action, Second Circuit held that *Italian Colors* compelled the conclusion that class action waiver in employment contract "is not rendered invalid by virtue of the fact that [plaintiff's claim under the Fair Labor Standards Act] is not economically worth pursuing individually").

144 Although FINRA arbitration can become expensive, particularly protracted, complex or larger cases that are heavily litigated, FINRA initial filing fees are not overly burdensome as they are based on a sliding scale (from $50 for claims under $1,000 to $1,800 for claims over $1,000,000), FINRA Rule 12900, and FINRA routinely defers or waives payment of fees if the claimant alleges a financial hardship. *Fee Waivers*, FINRA *available at* http://www.finra.org/ArbitrationAndMediation/Arbitration/Fees/FeeWaivers/index.htm (last visited Feb. 11, 2014).

gin to consider creative solutions for handling small investor claims.[145]

As an initial matter, the possibility that FINRA's prohibition on class action waivers may fall victim to the Supreme Court's increasingly expansive interpretation of the FAA has renewed calls for the SEC to exercise its authority under Section 15(o) of the Exchange Act and prohibit mandatory PDAAs.[146] One of the likely reasons the SEC has not limited or prohibited the use of PDAAs is because Section 15(o) contains a significant limitation—the SEC can only prohibit mandatory arbitration with respect to disputes arising under the federal securities laws, rules and regulations thereunder, and SRO rules.[147] A vast majority of customer claims allege violations of state law,[148] which would be subject to mandatory arbitration. Thus even if the SEC exercised its authority and prohibited PDAAs, firms would still be able to require arbitration of state law claims, effectively thrusting the industry back to the pre-*McMahon* bifurcation of federal and state claims.[149]

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145 Eliminating judicial class actions as a vehicle for resolution of small investor claims is a significant denial of substantive rights and remedies in an industry where customers have no real choice given the universal use of PDAAs in customer agreements. Constantine N. Katsoris, *The Trojan Horse Revisited*, 4 SEC. ARB. COMMENTATOR 3 (2013).

146 *See generally* Comments Submitted, Pre-Dispute Arbitration, Title IX Provisions of the Dodd-Frank Wells Street Reform and Consumer Protection Act, *available at* http://www.sec.gov/comments/df-title-ix/pre-dispute-arbitration/pre-dispute-arbitration.shtml. The North American Securities Administrators Association ("NASAA") sent a letter to the SEC on the heels of the *Schwab OHO Decision,* urging the SEC to exercise its authority under Dodd-Frank to ban mandatory arbitration provisions in light of *FINRA v. Schwab*. *Letter from A. Heath Absure, NASAA President, to SEC Chairman Mary Jo White*, SEC (May 3, 2013), *available at* http://www.sec.gov/comments/df-title-ix/pre-dispute-arbitration/predisputearbitration-21.pdf. Although NASAA expressed its preference for an outright ban, its appeal focused on the need to ensure the availability of the judicial class action as an avenue for the redress of small investor claims. *Id*.

147 15 U.S.C. § 78o(o).

148 FINRA reported 4,299 new arbitration cases filed in 2012, many of which alleged causes of action arising under state law, including negligence (45%), breach of fiduciary duty (51%), and breach of contract (37%). *FINRA Dispute Resolution Statistics*, FRINA, *available at* http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/ (last visited Feb. 11, 2014); *see also* Gross, *supra* note 4, at 519 ("[M]ost customer arbitrations today are predicated on state securities acts and common law claims such as breach of fiduciary duty, negligent misrepresentation, and fraud, and draw heavily on principles of equity.").

149 Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 220–21 (1985) (holding that in cases involving both non-arbitrable federal claims and state law claims that were subject to arbitration, FAA requires arbitration of arbitrable claims even if it would result in bifurcated proceedings and "'piecemeal' litigation"). *See also* Black, *supra* note 3, at 118–19; Black & Gross, *supra* note 7, at 23.

In the highly unlikely event that Congress passes the AFA,[150] bifurcation would no longer be an issue, but other problems persist. As Professor Black notes, if the AFA is passed and FINRA Rule 12200 (which requires brokers to arbitrate at the request of the customer) remains in effect, the industry will cry "foul" since the choice of arbitration is left solely to the customer.[151] Moreover, FINRA will effectively become a "small claims" forum because customers with large claims will go to court, while smaller claims (that are not subject to a judicial class action) will remain in FINRA, inevitably leading the industry to give up its strong support for FINRA arbitration.[152] If FINRA abrogates Rule 12200 to level the arbitration playing field, most or all investor claims will end up in the already overcrowded and costly court system[153]—a result that is not beneficial for most investors, especially those with smaller claims.[154]

Given the progress in the past two decades to improve securities arbitration procedures for customer claims, it would seem that the better course would be to build upon the existing system to better accommodate small claims. FINRA currently provides a

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150 Arbitration Fairness Act of 2013, S. 987, *available at* http://www.govtrack.us/congress/bills/113/s878, and H.R. 1844, *available at* http://www.govtrack.us/congress/bills/113/hr1844. The proposed legislation would amend the FAA by adding a new chapter invalidating PDAAs in consumer, investor, employment or civil rights claims. Friedman, *supra* note 4, at 1. "The AFA would effectively eliminate adhesion arbitration by invalidating pre-dispute arbitration agreements in almost every setting in which an individual is required to arbitrate disputes with another contracting party possessing greater bargaining power as a condition of doing business with that party." Aronovsky, *supra* note 105, at 177.

151 Black, *supra* note 3, at 121. The Securities Industry and Financial Markets Association (SIFMA), in fact took this position when the AFA was proposed in 2007, arguing in a white paper it published on securities arbitration that "[o]pponents of predispute arbitration agreements . . . seek neither fairness nor equality; rather, they seek an unfair strategic advantage. They want investors to retain their right to arbitrate as they see fit, but to deprive investment firms of the same right." *White Paper on Arbitration in the Securities Industry*, SIFMA-SIFMACL 3 (Oct. 2007), *available at* https://www.sifma.org/issues/item.aspx?id=21334.

152 Black, *supra* note 3, at 120.

153 Friedman, *supra* note 4, at 3; *see also* Aronovsky, *supra* note 105, at 178–79 ("[T]he AFA raises significant access to justice concerns by potentially foreclosing the availability of a faster, less expensive, and more informal dispute resolution process than court litigation for employees and consumers.").

154 Many investors fare better in arbitration than in court, because, among other things, the arbitral forum is speedy, inexpensive, and arbitrators are not necessarily bound to follow the letter of the law but, rather, strive to achieve an equitable result. Gross, *supra* note 4, at 519. In 2012, customers were awarded damages 45% of the time. FINRA Dispute Resolution Statistics, FINRA, *available at* http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/ (last visited Feb. 11, 2014).

simplified arbitration procedure for claims under $50,000,[155] which provides for disposition of a claim solely on the parties' written submissions. These "paper cases" are less costly because they are decided by one public arbitrator without a hearing.[156] FINRA's simplified arbitration procedure, however, still presents some significant challenges for the resolution of customer disputes.

First, the simplified arbitration process is complicated for many because it requires drafting and submission of a "statement of claim" that sets forth "the relevant facts" and remedies requested, and attaching any relevant documents to the customer's claim.[157] The process requires the selection of a public arbitrator by striking and ranking among a list of ten public arbitrators generated by FINRA (requiring research and a return of the parties' ranking forms within twenty days),[158] and could involve limited discovery.[159] This process is difficult for many to navigate without legal representation, which, in turn, is difficult to obtain for claims under $50,000. Without access to a law school securities arbitration clinic[160] or other pro bono representation, small claim investors are left with the choice of abandoning their claim altogether, or proceeding *pro se* in a system that, despite its title, is not easy to use.[161]

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155 FINRA Rule 12800,(*Simplified Arbitration)*, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4185.

156 *Id.*

157 FINRA Rule 12302 (*Filing an Initial Statement of Claim)* and 12800 (*Simplified Arbitration)*; *see also* Barbara Black, *supra* note 10, at 13.

158 FINRA Rule 12402.

159 FINRA Rule 12800.

160 In 1997 Pace Law School developed one of the first law school securities arbitration clinics, after then-SEC Chairman Arthur Levitt contacted Professor Barbara Black and asked if the law school would consider opening a clinic to assist investors whose claims were too small for them to obtain legal representation. Barbara Black, *Establishing a Securities Arbitration Clinic: The Experience at Pace*, 50 J. Legal Educ. 34, 37 (2000). Chairman Levitt had heard numerous complaints at town hall meetings he conducted throughout the country about the difficultly of small claim investors to find adequate and affordable legal representation in arbitration. *Id.*; *see also* Constatine L. Katsoris, *Securities Arbitration: A Clinical Experiment*, 25 Fordham Urban L. J. 193, 202 (1997–1998). Other law schools opened similar clinics, many with grants or proceeds from settlements issued to the law schools from the FINRA Foundation, the New York Attorney General, and the Pennsylvania Securities Commission. *Guidelines for Establishing a Law School Investor Advocacy Clinic*, Northwestern University School of Law & FINRA Foundation 29 (2009), *available at* http://www.finrafoundation.org/web/groups/foundation/@foundation/documents/foundation/p118734.pdf.

161 A 1997 study conducted by the Securities Arbitration Commentator ("SAC Study") showed that approximately 75% of the customer cases in simplified arbitration proceedings (at the time claims under $10,000) were *pro se*. *See SAC Award Survey: How Fares the Pro Se Investor In Arbitration?* 8 Sec. Arb. Commentator 1, 1 (1997). The SAC Study also found that represented investors fared far better than *pro se* investors, specifically, *pro se* investors who had their cases decided on the papers prevailed 45.9% of the time versus 51% for represented

Another important limitation of a "paper case" is that the matter is decided without a hearing. Aside from the claimant's desire to tell his or her story in a hearing, most customer disputes involve issues of credibility that are difficult to resolve solely on the papers.[162] While Rule 12800 provides the claimant with the option of requesting a hearing, the vast majority of claimants do not request a hearing,[163] likely because the costs of a full-blown hearing would outweigh the amount of the claims at issue in the first place.

FINRA continues to implement new pilots designed to help investors with small claims, such as its new "telephonic mediation" program.[164] Given perception of fairness problems presented by solely "paper cases,"[165] FINRA should consider a pilot program for "telephonic hearings" to provide small claims customers an option to speak to someone about their case and present their facts over the phone.[166] With the specter of a wave of new small investor claims flooding into arbitration should *Schwab*-type provisions be ultimately permitted, however, far bolder alternatives should be explored.

One alternative proposed by several scholars is that FINRA develop a "small claims arbitrator," where a professionally trained

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investors; *pro se* investors who requested a live hearing prevailed 41.7% of the time, while represented parties prevailed 55.4% of the time; and finally, *pro se* investors recovered 70.2% of what they sought while represented parties recovered 77%. *Id.* at 2.

Five years earlier, in 1992, a similar study was conducted by the United States General Accounting Office ("GAO"). *GAO Study: How Arbitration Fares*, 5 SEC. ARB. COMMENTATOR 1, 1 (1992) ("GAO Study"). The GAO Study found that investors represented by counsel settled roughly 1.7 times more than *pro se* claimants and that represented investors' recovery rates were 1.6 times more likely to exceed the average recovery rate when they did prevail. *Id.*

162 *Id. See also* Gross, *supra* note 65, at 49 ("'[W]here credibility and veracity are at issue . . . written submissions are a wholly unsatisfactory basis for decision.'") (citation and quotation omitted).

163 Customers requested a hearing approximately 15% of the time in cases under $25,000 from 2002–2008. Gross, *supra* note 65, at 72.

164 *See* FINRA News Release, *FINRA Launches Small Claims Telephonic Mediation Pilot Program*, FINRA (Jan. 16, 2013), *available at* http://www.finra.org/newsroom/newsreleases/2013/p197693. FINRA launched a pilot program for simplified cases, i.e., cases under $50,000, providing for *pro bono* and reduced-fee telephonic mediation. Mediators in the pilot program agreed to provide *pro bono* services for cases under $25,000, and a $50 per hour reduced fee services on cases between $25,000 and $50,000. Under the new pilot program, which is entirely voluntary, FINRA would not charge any administrative fees in connection with the mediation.

165 At least one empirical study has shown that customers have a decreased perception of fairness in arbitrations conducted without a hearing. Jill I. Gross & Barbara Black, *When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration*, 2008 J. DISP. RESOL. 349, 354 (2008).

166 Gross, *supra* note 65, at 81–82. "Because an arbitrator could listen to a witness tell a story and testify orally, telephonic hearings would presumably enhance fairness perceptions regarding the arbitration process for claimants and respondents alike." *Id.* at 82.

arbitrator can hold a short hearing limited to the customer and a brokerage representative telling their side of the story and the arbitrator issuing a prompt ruling.[167] Professor Black proposes that the customer be allowed to appear *pro se* or with an attorney, but that the brokerage firm be limited to a representative that is not an attorney.[168] Since presumably the vast majority of such "small claims" cases would be handled by the customer *pro se*, excluding an attorney for the firm may alleviate fairness concerns for the investor. Firms may well object, however, to participating in a procedure where they would be bound to an arbitrator's ruling without representation.[169]

Given the fact that many claims are too small even to justify the costs of simplified arbitration or a "small claims" process, however, some scholars have argued that it is time re-think class arbitration.[170] Although the majority in *Concepcion* demonstrated a hostility towards class arbitration, stating that it would "interfere[ ] with the fundamental attributes of arbitration" and defeat the purposes of the FAA,[171] in *Oxford Health*[172] the Court unanimously held that if the parties to an arbitration agreement consent to class procedures, the FAA required enforcement of that agreement.[173]

Moreover, the limitations of class arbitration raised by the Court in *Concepcion* are based upon trying to accommodate a "class" action within the confines of procedures designed for individual cases. This is especially true in the context of securities arbi-

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167 Black, *supra* note 10, at 13–14; *see also* Gross, *supra* note 65, at 82.

168 Black, *supra* note 10, at 14.

169 A better approach may be to simply disallow attorney representation for either party, as suggested Professor Gross, since the trained "small claims arbitrator" would presumably elicit the facts from both sides through questioning. Gross, *supra* note 65, at 82.

170 Ann Marie Tracey & Shelley McGill, *Seeking a Rational Lawyer for Consumer Claims After the Supreme Court Disconnects Consumers in* AT&T Mobility v. Concepcion, 45 LOY. L.A. L. REV. 435, 463–64 (2012); *see also* Bondi, *supra* note 53, at 635–36 (Bondi explores the use of class arbitrations in a larger setting, i.e., including class actions against issuers, and argues that a system could be developed—using FINRA as a model—to provide for some judicial oversight (requiring judicial review through the motion to dismiss stage, and post-award judicial review) and greater arbitrator flexibility to allow discovery).

171 AT&T Mobility, LLC v. Concepcion, 131 S. Ct. 1740, 1748, 1755 (2011). Among other things, the Court expressed concerns about the procedural informalities of arbitration and how structurally it was ill-suited to implement the class procedures used in judicial class actions, the expertise among arbitrators to rule on class certification issues, and the ability to bind absent class members under such informal procedures. *Id.* at 1750. The Court also observed that class arbitration would "greatly increase" risks to defendants due to the lack of multilayered review which is available in judicial proceedings. *Id.* at 1752. "Arbitration is poorly suited to the higher stakes of class litigation." *Id.*

172 Oxford Health Plans, LLC v. Sutter, 133 S. Ct. 2064, 2070–71 (June 10, 2013).

173 *Id.*

trations, since SROs have barred representative actions for over two decades. Whether (and how) FINRA arbitration could implement a procedure for representative arbitrations is beyond the scope of this article, but it would seem that many of the concerns raised about class arbitrations could be addressed by developing a separate track for class arbitrations with broader procedures designed to provide for, among other things, notice and opt out procedures, greater pre-hearing discovery, specially trained arbitrators and greater judicial review.[174]

VI. Conclusion

During the twenty-five years since *McMahon* pushed the vast majority of customer disputes into arbitration, there have been significant reforms—under the guidance of the SEC—designed to make FINRA arbitration more efficient and transparent, less costly, easier to understand and fairer to investors. As the SEC and SROs recognized in 1992,[175] however, investors should have the ability to seek redress of small claims in judicial class actions. Indeed, the class actions against Schwab regarding its *Yield Plus* funds—which likely prompted Schwab to insert a class action waiver in its customer agreements in 2011—perfectly illustrate why judicial class actions are a critical tool in addressing investor claims shared by a large group of investors: the average investor claim was $881.[176] It would simply not be economically feasible to pursue these claims even under FINRA's simplified arbitration process. *FINRA v. Schwab* threatens to foreclose this critical tool for the resolution of securities claims.

There are reasons to be optimistic that FINRA's prohibition against judicial class action waivers will ultimately be upheld. The multilayered and self-regulatory structure under which the securities industry operates provides compelling arguments supporting FINRA's ability to regulate PDAAs in broker-customer agreements. Recent amendments to the Exchange Act, moreover, pro-

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174 *See, e.g.*, Bondi, *supra* note 53, at 635–36. *But see* Marti H. Malin, *The Arbitration Fairness Act: It Need Not and Should Not Be an All or Nothing Proposition*, 87 Ind. L.J. 289, 313–14 (2012) (procedural due process issues raised by class actions are heightened in the context of arbitrations; argues that the FAA should be amended to preclude class actions in arbitration).

175 SEC Order Relating to the Exclusion of Class Actions from Arbitration Proceedings, *supra* note 53.

176 *See supra* note 67.

vide "clear congressional intent" to vest the SEC with authority to regulate the terms and use of PDAAs in the securities industry.

Given *Concepcion* and *Italian Colors*, however, there is a very real risk that FINRA's prohibition against class action waivers will also fall victim to the Supreme Court's increasingly broad interpretation of the FAA.[177] In that case there will undoubtedly be enormous pressure on the SEC to act under its authority and ban mandatory PDAAs. Instead, the SEC should consider a more limited option, specifically, using its authority to prohibit waivers of judicial class actions in PDAAs. This will serve to preserve both a judicial forum for small claims that cannot be brought on an individual basis in a cost-effective manner, as well as an alternative dispute resolution forum that provides an efficient, cost-effective and generally fair process for resolution of investor disputes.[178] In the meantime, FINRA should begin to consider new pilot programs for small claims, regardless of where *FINRA v. Schwab* may lead.

177 In fact, if the NAC does not reverse the *Schwab OHO Decision*, the decision will stand because section 19(h)(d)(2) only provides for appeal by member or associated person that is subject to a disciplinary order. 15 U.S.C. §78s(d)(2).

178 As Professor Katsoris warns, "the public will not accept being forced into an arbitration system where its rights and remedies are unilaterally stripped or limited by non-negotiated form or otherwise adhesive agreements. Simply put, SRO arbitration cannot—under the guise of speed and economy—be used as a Trojan Horse to cherry-pick away the claimant's rights." Katsoris, *supra* note 145, at 3.