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Expert Analysis

How 'AT&T Mobility' Changes the Course Of Securities Class Actions, Arbitrations

In its recent decision in *AT&T Mobility LLC v. Concepcion*,[1] the U.S. Supreme Court held that the Federal Arbitration Act (FAA) preempts state law unconscionability defenses to arbitration clauses that contractually waive the right to class determination of claims in litigation and arbitration. As numerous commentators have already recognized, the impact of this opinion is likely to reach well beyond its original consumer context. In particular, *AT&T Mobility* has the potential to drastically alter the conduct of class actions and arbitrations in the securities industry.

Until recently, FINRA rules, which prevented member firms from compelling class litigants to arbitrate their disputes, complicated the use of class arbitration waivers in agreements between securities firms and their employees, customers and counter-parties. However, the broad language of *AT&T Mobility*, in conjunction with recent rulings interpreting the relevant FINRA rules, may severely undercut those rules, allowing securities firms to make far greater use of class arbitration waivers.

'AT&T Mobility' Ruling

The *AT&T Mobility* decision grew out of a consumer class action, not a securities matter. In that case, the U.S. Court of Appeals for the Ninth Circuit had invalidated a class arbitration waiver in a consumer contract on the basis of a California Supreme Court rule allowing courts to overturn certain categories of class arbitration waivers as unconscionable. In a 5-4 opinion authored by Justice Antonin Scalia, the Supreme Court found that the California rule was preempted by Section 2 of the FAA, which makes agreements to arbitrate "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."[2]

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In making this finding, the Court applied what amounted to a two-step analysis. First, it considered whether the California rule fell within the definition of "generally applicable contract defenses, such as fraud, duress, or unconscionability but not…defenses that apply only to arbitration or that derive their meaning from the fact that an agreement to arbitrate is at issue."[3] Second, the Court considered whether the California rule "interfere[d] with the fundamental attributes of arbitration and thus create[d] a scheme inconsistent with the FAA," a "principal purpose" of which was to ensure that "private arbitration agreements are enforced according to their terms."[4]

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The Court noted that the California rule applied to waivers of class rights in both the litigation and arbitration contexts, but nevertheless concluded that it interfered with the "fundamental attributes of arbitration." According to the Court, while individual arbitration allows for "efficient, streamlined procedures tailored to the type of dispute," and provides an informal proceeding which reduces "the cost and increase[es] the speed of dispute resolution," class arbitrations discourage defendants from resolving individual arbitrations, encourage attorneys to bring class actions instead of individual arbitrations, generally "make[] the process slower, more costly, and more likely to generate procedural morass than final judgment" and are poor procedural vehicles for the resolution of class claims.[5] The Court, therefore, determined that, because the California rule interfered with the fundamental attributes of arbitration, it created a scheme which was inconsistent with Section 2 of the FAA.

Effect on Securities Firms

One obvious consequence of *AT&T Mobility* is that corporations and other potential defendants that regularly enter into consumer contracts will likely step up their use of class arbitration waiver clauses. However, *AT&T Mobility* also may portend a similar benefit for investment and securities firms.

Class arbitration waivers have significant potential application when securities firms sign contracts with customers, employees or other firms. For example, securities firms may be able to include and enforce such clauses in agreements relating to private placements, customer brokerage accounts, investments in hedge funds, PIPEs, and employment contracts with broker-dealers or investment advisers, among other contexts.

Direct investments with private investment funds frequently require investors to sign lengthy subscription agreements complete with arbitration clauses. In such cases, the ability to require customers or investors to bring their disputes into arbitration and to do so as individual claims and prevent them from banding together as a class, may reduce significantly the firms' potential liability. For example, a hedge fund sued by its investors for accounting fraud may be able to compel each investor into an individual arbitration.

In the past, however, securities firms had faced a significant obstacle to enforcement of class arbitration waivers that did not affect their non-securities counterparts—FINRA's Code of

Arbitration Procedure. While not every participant in the securities industry is a member of FINRA, the majority of firms are obliged by statute, regulation and contract to comply with FINRA rules. Those rules, at least until recently, prevented the operation of class arbitration waivers by member firms.

Specifically, Rule 12204(a) of FINRA's Code of Arbitration Procedure for Customer Disputes states that "[c]lass action claims may not be arbitrated under the Code." Rule 12204(d) forbids members and associated persons from enforcing arbitration agreements against members of certified or putative class actions, stating that:

> A member or associated person may not enforce any arbitration agreement against a member of a certified or putative class action 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.
> This paragraph does not otherwise affect the enforceability of any rights under the Code or any other agreement.[6]

Acting in conjunction, these two sections of Rule 12204 prevented member firms from compelling class action litigants to arbitration. Moreover, courts interpreting NASD Rule 10301(d)(3)—the predecessor to Rule 12204(d)—specifically found that the rule prohibited NASD members from using class arbitration waivers to compel arbitration of claims that are proceeding as putative or certified class actions.[7]

FAA and Rule 12204(d)

However, the breadth of the *AT&T Mobility* ruling raises the thorny question of whether the FAA could preempt Rule 12204(d). Courts have, in the past, treated the application of FINRA rules to FINRA members as a matter of contract law.[8] If this premise holds sway, FINRA members, by joining FINRA and agreeing to be bound by its rules, have contracted away their own right to seek a class arbitration waiver, regardless of *AT&T Mobility*. The FAA should have no bearing on these private contract rights, as members are as free under the FAA to contract away their rights to arbitrate as they are to do the opposite.

Nevertheless, given the robust powers of preemption ascribed to the FAA by Justice Scalia in A*T&T Mobility*, a party seeking to enforce a class arbitration waiver might successfully argue that Rule 12204(d) itself runs afoul of Justice Scalia's two-part test and therefore is preempted by the FAA. First, while the statutes empowering FINRA and the SEC to promulgate rules are neutral with respect to class arbitration waivers, those statutes, through Rule 12204(d), arguably have been applied to create defenses "that apply only to arbitration or that derive their meaning from the fact that an agreement to arbitrate is at issue." Moreover, those statutes have resulted in a FINRA rule that arguably "interferes with the fundamental attributes of arbitration" by privileging class actions over arbitrations in the face of contrary contractual provisions.

Moreover, a subtle change in the language of the rule from the predecessor NASD Rule 10301(d)(3) to the current FINRA Rule 12204(d) may have significantly altered the analysis of the validity of class action waivers for contracts entered into by FINRA members. The predecessor rule, NASD Rule 10301(d)(4), stated that "[n]o member or associated person shall be deemed to have waived any of its rights under this Code or under any agreement to arbitrate to which it is party except to the extent stated in this paragraph." Conversely, the new rule, FINRA Rule 12204(d), effective from Dec. 15, 2008, states only that "This paragraph does not otherwise affect the enforceability of any rights under the Code or any other agreement," removing the qualifying "except to the extent stated in this paragraph" language.

Following the excision of that limiting language, a federal district court recently held that FINRA's action in removing the "except to the extent stated in this paragraph" language indicated its intent to no longer bind parties solely to the provisions stated in the rule.[9] Thus, according to the court, since the class arbitration waiver fell under the "any other agreement" exception to rule 12204(d), it was enforceable.[10] That court therefore held that the defendant, a FINRA member, could rely on its class arbitration waiver to prevent plaintiff employees from instituting a class action and to compel those plaintiffs to proceed to arbitration on their individual claims.

Another court further limited the application of Rule 12204(d) by holding that it only applies to FINRA members in their capacity as broker-dealers, not in their capacity as investment advisers.[11] Under that analysis, FINRA members can enforce class arbitration waivers to the extent they act in a non-broker-dealer capacity. Finally, participants in the securities industry who are not FINRA members—unregistered hedge funds in particular—are under no obligation to follow the strictures of Rule 12204.

Given the sweeping nature of the *AT&T Mobility* ruling and the increased flexibility of Rule 12204(d), the use of class arbitration waivers in the securities industry is likely to become increasingly common and increasingly effective.

1. 131 S. Ct. 1740, __U.S.__ (2011).
2. Id. at 1744 (quoting 9 U.S.C. §2).
3. Id. at 1746 (internal quotations omitted).
4. Id. at 1748 (quoting *Volt Info. Sciences Inc. v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 478, 109 S. Ct. 1248, 1255 (1989).
5. Id. at 1749, 1751-53.
6. FINRA Rule 12204(d). Rule 13204(d) applies precisely the same language to industry disputes. This article refers to Rule 12204(d) and 13204(d) interchangeably.
7. See e.g., *Good v. Ameriprise Fin. Inc.*, CIV.06 1027 PJS/RLE, 2007 WL 628196 (D. Minn. Feb. 8, 2007); *Coheleach v. Bear, Stearns & Co. Inc.*, 440 F.Supp.2d 338, 341 (SDNY 2006).
8. See *Fiero v. Fin. Indus. Regulatory Auth. Inc.,* 606 F.Supp.2d 500, 507 (SDNY 2009) ("[W]hile the Exchange Act and the regulations promulgated under it do empower FINRA to operate as an SRO, neither the Exchange Act nor the SEC directly administers the disciplinary proceedings or imposes the fines. Instead, FINRA conducts those activities as a private corporation and binds its members through contract. Therefore, it is the contractual relationship between FINRA and the Fieros that creates FINRA's right to collect, not federal statute").
9. See *Suschil v. Ameriprise Fin. Servs. Inc.*, 1:07CV2655, 2008 WL 974045, at *6 (N.D. Ohio April 7, 2008).
10. Id.
11. See *Bakas v. Ameriprise Fin. Services Inc.*, 651 F.Supp.2d 997, 1003 (D. Minn. 2009) ("it is clear that the rules refer to the activities of a broker/dealer, not an investment adviser, when precluding arbitration by a 'member'").

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