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Expert Analysis

'Concepcion's' Lasting Effects: Class Action Waivers Preempt FINRA Rules

In our June 24, 2011, article for Outside Counsel, titled "How 'AT&T Mobility' Changes the Course of Securities Class Actions, Arbitrations," we discussed the then-recent U.S. Supreme Court decision in *AT&T Mobility v. Concepcion*.[1] At that time, we predicted that *Concepcion*, which held the Federal Arbitration Act (FAA) preempts state law defenses to contractual class action and arbitration waivers, would likely lead to a conflict between the FAA and long-standing FINRA rules prohibiting member firms from compelling class litigants to arbitrate their disputes. Almost two years after *Concepcion*, that prediction has come true.

On Feb. 21, 2013, a FINRA Hearing Panel issued a detailed, 48-page opinion in the matter of *Department of Enforcement v. Charles Schwab & Co.*, holding that, consistent with *Concepcion*, the brokerage could not be penalized by FINRA for inserting a class action and arbitration waiver provision into their customer agreements.[2] While there remains a possibility that the opinion will be overturned, the decision's reasoning is sound and will likely result in other brokerage firms following Schwab's lead.

'Concepcion'

In *Concepcion*, the Supreme Court reviewed a U.S. Court of Appeals for the Ninth Circuit ruling invalidating a class arbitration waiver in a consumer contract on the basis of a state court rule allowing courts to overturn certain categories of class arbitration waivers as unconscionable. The court held that the state law 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."[3]

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In so doing, the court held that the state rule "interfere[d] with the fundamental attributes of arbitration" because, 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 are poor procedural vehicles for the resolution of class claims, discourage defendants from resolving individual arbitrations, encourage attorneys to bring class actions instead of individual arbitrations and generally "make[] the process slower, more costly, and more likely to generate procedural morass than final judgment."[4] Therefore, the state rule was inconsistent with the FAA, a "principal purpose" of which was to ensure that arbitration agreements between private parties are enforced.[5]

While *Concepcion* did not address federal securities laws or regulations, the securities industry took notice. Less than six months later, and avowedly in reliance upon *Concepcion*, Schwab, one of the world's largest retail brokerage houses, sent notifications to more than 6.8 million customers that their account agreements were being amended. The amendments took effect upon notification and included the following waiver of the right to pursue claims through class action or arbitration:

> 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 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.

Schwab also incorporated these terms into its new customer agreements.

> A FINRA hearing panel held that Schwab could not be penalized by FINRA for inserting a class action and arbitration waiver provision into their customer agreements.

The FINRA Action

Soon after, FINRA's Department of Enforcement initiated a disciplinary proceeding against Schwab seeking sanctions against the company and removal of the waiver from their customer agreements. The Department of Enforcement alleged that Schwab's waiver violated FINRA rules requiring FINRA members to exempt class actions from their arbitration clauses.

The FINRA Hearing Panel overseeing the proceeding focused on two questions: (1) did Schwab's waiver conflict with FINRA's rules and (2) if so, were FINRA's rules preempted by the FAA. In an opinion issued without dissent, the panel answered both questions in the affirmative.

The panel first addressed the threshold question of whether there was any conflict. Rule 12204 of FINRA's Code of Arbitration Procedure for

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Customer Disputes specifically addresses the status of class action claims in FINRA arbitration. Rule 12204(a) states that "[c]lass action claims may not be arbitrated under the Code," while Rule 12204(c) forbids members and associated persons from enforcing arbitration agreements against members of certified or putative class actions, unless the class certification is denied or the class is decertified, or unless the member is excluded or withdraws from the class.[6]

FINRA Rule 2268(d) concurrently mandates that "[n]o predispute arbitration agreement shall include any condition that: (1) limits or contradicts the rules of any self-regulatory organization; …(3) 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." The panel therefore held that both Rules 2268(d)(1) and (d)(3), acting in conjunction with Rule 12204, banned the use of class action waivers by FINRA members—a ruling supported by a number of court opinions and longstanding FINRA and industry practice.[7]

The panel next turned to the thornier question of whether the FAA preempts FINRA Rules 2268 and 12204—apparently a question of first impression. As an initial matter, the panel noted that Section 2 of the FAA, by its own terms, applies to any written agreement to arbitrate, observing also that Schwab, FINRA and numerous courts have previously concurred that the FAA applies to FINRA's arbitration rules and its members' arbitration agreements. This, according to the panel, put the FAA in direct conflict with FINRA Rules 2268 and 12204.

The panel further held that, under the holdings of *Concepcion* and a number of additional Supreme Court precedents, the FAA's mandate that arbitration agreements be "valid, irrevocable, and enforceable" outweighs any countervailing rule or law—be it state, federal or regulatory—unless "overridden by a contrary congressional command," with the burden of proving such a command placed on the party opposing arbitration.[8] The panel then observed that FINRA's rules, promulgated pursuant to the Securities and Exchange Commission's delegation of authority, and approved by the SEC, are subject to the same strictures.

Finally, the panel concluded that nothing in the securities laws carved out FINRA's regulations as an exception to the general applicability of the FAA—and noted, to the contrary, that the Supreme Court repeatedly has relied on the FAA to enforce arbitration clauses in claims brought under federal securities statutes.[9]

Next Steps

The Department of Enforcement already has declared its in-tention to appeal.[10] Under FINRA's own code of procedure, the panel's decision must first be appealed to FINRA's National Adjudicatory Council (NAC), a body composed of securities professionals and non-industry representatives.[11] Following a ruling by the NAC, FINRA's Board of Governors may, at its own discretion, choose to review the result—certainly a strong possibility here given that the panel's decision directly affects FINRA's own rules.[12] If the final decision issued by the NAC or the board goes against Schwab, Schwab may pursue a further appeal to the SEC (and ultimately to a federal circuit court), though the Department of Enforcement does not have the same option of appealing an unfavorable decision to the SEC.[13]

The FINRA hearing panel concluded that nothing in the securities laws carved out FINRA's regulations as an exception to the general applicability of the Federal Arbitration Act.

On appeal, the Department of Enforcement has limited arguments available. Most tribunals hearing challenges to class arbitration waivers in the wake of *Concepcion* have upheld those waivers and enforced arbitration clauses. Moreover, the general thrust of the court's jurisprudence in recent years has been in favor of arbitration.

One possible ground for appeal lies in the doctrine upheld in the U.S. Court of Appeals for the Second Circuit's recent decision in the *American Express* litigation.[14] In this post-*Concepcion* opinion, the Second Circuit, relying on older Supreme Court precedent, held that class action waivers are unenforceable when a plaintiff is able to demonstrate that "their statutory rights cannot be vindicated through individual arbitrations."[15] While *Amex* arose in the antitrust context, the decision is transferrable to the securities law arena.

The strength of the *Amex* pre-cedent, however, is in serious question following *Concepcion*. The Supreme Court granted certiorari in the *Amex* case and oral argument took place on Feb. 27, 2013, with a decision anticipated sometime this spring. Moreover, even if *Amex* is upheld, FINRA's Department of Enforcement is likely to face an uphill battle. *Amex* arose out of a specific set of factual circumstances, and plaintiffs in that case presented evidence that the cost of an economic expert would outweigh any possible individual recovery. However, to secure sanctions against Schwab and reformation of its customer agreements, the Department of Enforcement would have to argue in the abstract that FINRA's arbitral forums are, as a matter of law, so inadequate to vindicate any federal statutory rights that might be asserted in a class action that the *Amex* exception would apply across the board to any class litigation that might be subject to Schwab's waiver.

The *Schwab* panel explicitly addressed both of those arguments in its opinion, noting its doubts that *Amex* can survive *Concepcion* and that "a finding that SRO arbitration is insufficient to protect investors' substantive rights… would fly in the face of decades of judicial, legislative, and regulatory history endorsing the securities industry arbitration system."[16] Nevertheless, while a successful disciplinary action by FINRA seems unlikely, putative class members still might overturn a waiver under the right circumstances, so long as the Supreme Court upholds the *Amex* doctrine in some form.

Conclusion

Although *Schwab* altered its customer agreements to take advantage of *Concepcion*, a review of selected customer agreements indicates that other major brokerages did not do so, apparently hesitant to follow Schwab and face similar enforcement action. However, given the obvious benefits of such waivers to the securities industry—the elimination of all customer or employee class actions—the probability that other brokerages will follow Schwab's lead is high. Thus, barring a successful appeal or lobbying effort to Congress for a carve-out, a change in most customer agreements to encompass class action waivers is likely.

1. 131 S. Ct. 1740, —U.S.— (2011).
2. FINRA Disciplinary Proceeding No. 2011029760201 (the panel opinion referred to in this article may be found at: http://disciplinaryactions.finra.org/viewdocument.aspx?DocNB=33101).
3. 131 S. Ct. at 1744 (quoting 9 U.S.C. §2).
4. Id. at 1749, 1751-53.
5. Id. at 1748.
6. FINRA Rule 12204(a) and (d). Rule 13204(d) applies the same language to intra-industry disputes.
7. See e.g., *Good v. Ameriprise Fin.*, 2007 WL 628196 (D. Minn. Feb. 8, 2007) (interpreting Rule 13204); *Coheleach v. Bear, Stearns & Co.,* 440 F.Supp.2d 338 (S.D.N.Y. 2006) (same); but see *Cohen v. UBS Fin. Servs.*, 2012 U.S. Dist. LEXIS 174700 (S.D.N.Y. Dec. 4, 2012) (holding that the waiver at issue did not conflict with FINRA's industry-related rules); *Suschil v. Ameriprise Fin. Servs.*, 2008 WL 974045, at *6 (N.D. Ohio April 7, 2008) (same).
8. *Shearson/Am. Exp. v. McMahon*, 482 U.S. 220, 226-27 (1987).
9. In that same opinion, the panel also ruled that the FAA did not allow Schwab to mandate a waiver of FINRA's consolidation rules. The panel rejected Schwab's argument that those rules will enable arbitrators to create de facto class actions, as those rules only allow arbitrators to combine separately filed individual claims.
10. Beth Winegarner, "FINRA to Renew Fight Against Schwab's Class Action Waiver," LAW360, Feb. 26, 2013.
11. FINRA Rule 9310 and 9351.
12. FINRA Rule 9351.
13. FINRA Rule 9370.
14. *In re Am. Exp. Merchants' Litig.*, 667 F.3d 204, 210 (2d Cir. 2012) cert. granted, 133 S. Ct. 594 (2012) (*Amex*).
15. Id. at 215-16.
16. *Schwab,* Op. at 39 n.89. See also *Shearson*, 482 U.S. at 233-34 (noting that FINRA's procedures were approved and overseen by the SEC).