FINANCIAL INDUSTRY REGULATORY AUTHORITY
NATIONAL ADJUDICATORY COUNCIL

Department of Enforcement, Complainant, v. Charles Schwab & Company, Inc. (CRD No. 5393), Respondent.	**DISCIPLINARY PROCEEDINGS** **NO. 2011029760201**

BRIEF OF AMICI PROFESSORS BARBARA BLACK AND JILL GROSS

IN SUPPORT OF FINRA'S OPENING BRIEF

Barbara Black
Charles Hartsock Professor of Law
Director, Corporate Law Center
University of Cincinnati College of Law
P.O. Box 21140
Cincinnati, OH 45221
513-556-0113
barbara.black@uc.edu

Jill I. Gross
Professor of Law
Director of Legal Skills
Pace Universtiy School of Law
78 N. Broadway
White Plains, NY 10603
(914) 422-4061
jgross@law.pace.edu

TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES

STATUTES

RULES

LAW REVIEW ARTICLES

MISCELLANEOUS AUTHORITIES

INTRODUCTION

We are two law professors who frequently author scholarship in the areas of securities arbitration and investor protection.[1] We respectfully submit this amicus brief in support of the Department of Enforcement's Opening Brief to bring to the attention of the National Adjudicatory Council (NAC) additional legal and policy arguments that support reversal, in part, of the Hearing Panel's rulings in this proceeding. For the reasons detailed below,[2] we urge the NAC to reverse the Hearing Panel's ruling that the Federal Arbitration Act (FAA) bars the Financial Industry Regulatory Authority (FINRA)[3] from enforcing its Rules 2268(d)(1) and (d)(3) and NASD Rules 3110(f)(4)(A) and (f)(4)(C) with respect to the class action waiver.[4]

The issue at the heart of this disciplinary proceeding is the broad authority of FINRA and the Securities and Exchange Commission (SEC), working together pursuant to the Securities Exchange Act of 1934 (the Exchange Act), 15 U.S.C. §§ 78a-78pp (2006 and Supp. V 2011), to regulate the arbitration agreements Charles Schwab & Co. (Schwab) requires its brokerage customers to sign, in order to promote investor protection and protect the public interest. In upholding the enforceability of agreements to arbitrate federal securities claims, the U.S. Supreme Court expressed its confidence that investors could adequately vindicate their rights in an arbitration forum administered by a Self-Regulatory Organization (SRO) because "the [Securities and Exchange] 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*

---

[1] Pursuant to FINRA's Amicus Brief Guidelines, we disclose that we solely authored this brief without assistance or input from counsel to any party to this proceeding. We also disclose that we received no monetary contributions or funding of any kind from any counsel or party in support of the preparation and/or submission of this brief. We further disclose that Professor Black was a member of FINRA's National Adjudicatory Council from 2009-2011, and Professor Gross was a member of FINRA's National Arbitration and Mediation Committee from 2006-09.

[2] These arguments are set forth in more detail in Barbara Black and Jill Gross, *Investor Protection Meets the Federal Arbitration Act*, 1 Stan. J. Complex. Litig. 1 (2012).

[3] References to FINRA include its predecessors NASD and NASD Dispute Resolution.

[4] We take no position with respect to the remainder of the rulings of the Hearing Panel in this proceeding.

of any rules it deems necessary to ensure that arbitration procedures adequately protect statutory rights." *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 233-34(1987) (footnote omitted, emphasis added); *see also Rodriguez de Quijas v. Shearson/American Exp., Inc.*, 490 U.S. 477, 486 (1989) (finding that "resort to the arbitration process does not inherently undermine any of the substantive rights afforded to petitioners under the Securities Act"). The Supreme Court thus recognized that Congress bestowed upon the SEC and FINRA broad authority to regulate the broker-dealer industry, including its arbitration system, in order to protect investors.

After *McMahon*, virtually all brokerage firms included predispute arbitration agreements in their customer agreements (PDAAs), and the FINRA arbitration system became the principal method of resolving individual disputes between broker-dealers and their customers. As a result, FINRA, which operates the largest securities arbitration forum in the world, engages in ongoing review and reform of its arbitration rules to assure a fair arbitration system that meets the needs of the securities industry and investors. The SEC plays an integral role through its review and approval of the arbitration rules, consistent with the mandate to protect investors and the public interest.

Despite this broad investor protection mandate from Congress, the Hearing Panel determined that the Federal Arbitration Act (FAA), 9 U.S.C. § 1 *et seq.* – which was enacted in 1925 and has not been materially amended since – prevents FINRA from disciplining Schwab for requiring its customers to accede to a class action waiver that is prohibited by specific FINRA rules approved by the SEC. The Hearing Panel's Decision mischaracterizes FINRA's rules and describes them as "represent[ing] the kind of 'hostility' to arbitration" prohibited by the Supreme Court. [Decision at 9] The Hearing Panel's Decision also reflects confusion about what this case is about. This case has nothing to do with "[r]equiring the availability of classwide arbitration." [Decision at 41] Indeed, neither party has argued that classwide arbitration should be available to brokerage firm customers. Rather, FINRA Enforcement simply asked the Hearing Panel to enforce Schwab's membership agreement with FINRA and uphold the judgment of FINRA and the SEC that brokerage customers should have access to the courts for class actions in appropriate cases. Congress itself has acknowledged the importance of class actions to protect investors and the public interest in the Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737, and reaffirmed regulatory authority to address securities arbitration in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), Pub. L. No. 111-203, 124 Stat. 1376 (2010).

Unless reversed on appeal, the Hearing Panel's Decision deals a crippling blow to the authority of FINRA and the SEC to adopt arbitration rules that balance the benefits of arbitration with the need to protect investors.[5]

I. THE FEDERAL ARBITRATION ACT DOES NOT LIMIT THE BROAD AUTHORITY OF THE SEC AND FINRA, PURSUANT TO THE SECURITIES EXCHANGE ACT, TO REGULATE ARBITRATION AGREEMENTS BETWEEN BROKER-DEALERS AND CUSTOMERS IN ORDER TO PROTECT INVESTORS

A. Supreme Court Precedent Contradicts the Hearing Panel's View That the Requisite Congressional Command Has to Stem from Explicit Statutory Language

In *CompuCredit Corp. v. Greenwood*, 132 S. Ct. 665 (2012), the Supreme Court reaffirmed the long-standing principle that the mandate of the FAA is not absolute: it may be "overridden by a 'contrary congressional command.'" *Id.* at 669 (quoting *McMahon*, 482 U.S. at

[5] We agree with FINRA Enforcement that the Hearing Panel considered the enforceability of the wrong agreement: FINRA did not institute this disciplinary action to enforce an arbitration agreement between Schwab and its customers. Nevertheless, we recognize that the Hearing Panel properly considered whether the FAA imposes any limitations on securities regulators' authority to regulate arbitration agreements pursuant to the Exchange Act. As set forth in this amicus brief, we contend that the FAA does not limit that authority.

226). Thus, the Hearing Panel correctly ruled that the "critical issue on which this case turns is whether Congress has created an exception from the FAA either for FINRA's rules or for the subject matter of those rules – judicial class actions in securities disputes between customers and industry members." [Decision at 40]

The Hearing Panel, however, very narrowly construed what constitutes a Congressional exception from the FAA and, as a result, incorrectly concluded that "Congress has created no such exception." [Decision at 40] In its view, "FINRA's promulgation of a Rule pursuant to SEC approval and oversight that preserves judicial class actions as an option is not the same as a *congressional* command creating an exception to the FAA," and "FINRA's general authority to promulgate Rules is not a *congressional* command to promulgate the *particular* Rule carving out an exception to the FAA." [Decision at 41, emphasis in original] In other words, the Hearing Panel took the position that Congress itself had to override specifically the FAA.

The Supreme Court, however, has expressly rejected this overly narrow view of what constitutes an adequate "contrary congressional command." In *McMahon,* the Court explained that the necessary Congressional intent to overcome the FAA would be "'deducible from [the statute's] text or legislative history,' or from an inherent conflict between arbitration and the statute's underlying purpose." *McMahon,* 482 U.S. at 226-27 (*citing Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628, 632-37 (1985)). In other cases reconciling a conflict between two federal laws, the Court has found the requisite Congressional command in SEC regulations and SRO conduct rules. *See Credit Suisse Securities (USA) LLC v. Billing*, 551 U.S. 264, 270-84 (2007) (finding that the federal antitrust laws were impliedly repealed by the Exchange Act, as expressed through SEC and SRO regulations of IPO sales practices, in antitrust class action against investment banks for laddering and tying during IPOs); *Gordon v. New York*

Stock Exchange, 422 U.S. 659, 689 (1975) (finding that Exchange Act impliedly precluded application of the Sherman Act to investors' challenge as anticompetitive the New York Stock Exchange's and American Stock Exchange's rules that fixed commission rates in light of the Exchange Act text as well as legislative history of recent amendments specifically authorizing the SEC to fix reasonable rates of commission);[6] *United States v. National Association of Securities Dealers*, 422 U.S. 694, 700-02, 734-35 (1975) (finding that SEC regulations and NASD rules that restricted the transferability of mutual fund shares on the secondary market for a price other than the initial public offering displaced Sherman Act prohibition on anticompetitive agreements among mutual funds because the SEC had oversight authority over the activity).

Thus, the Hearing Panel incorrectly imposed a requirement – contradicted by ample Supreme Court precedent -- that only explicit language in a Congressional Act can overcome a conflicting federal statute.

B. The Securities Exchange Act of 1934 Contains the "contrary congressional command" Required by *Compucredit*

In adopting the Exchange Act in 1934 and in subsequent amendments, Congress recognized that securities transactions are "affected with a national public interest which makes it necessary to provide for regulation and control of [securities] transactions and of practices and matters related thereto." Exchange Act § 2, 15 U.S.C. § 78b. The importance of investor protection and the public interest is pervasive throughout the Exchange Act and in the regulation

[6] Notably, the Court declared:

> Sometimes regulatory statutes explicitly state whether they preclude application of the antitrust laws. Where regulatory statutes are silent in respect to antitrust, however, courts must determine whether, and in what respects, they implicitly preclude application of the antitrust laws. Those determinations may vary from statute to statute, depending upon the relation between the antitrust laws and the regulatory program set forth in the particular statute, and the relation of the specific conduct at issue to both sets of laws.

Id. at 270-71 (internal citations omitted).

of broker-dealers.

Congress assigned the front-line authority for regulating the broker-dealer industry to SROs, principally FINRA, through a system of self-regulation. Thus, the Exchange Act *requires* FINRA to adopt rules for the purpose of "in general, [protecting] investors and the public interest." Exchange Act § 15A(b)(6), 15 U.S.C. § 78*o*-3(b)(6). Congress also adopted a comprehensive system of SEC oversight over FINRA, including its arbitration forum, in order that self-regulation could achieve its purpose of protecting investors and serving the public interest. In 1975, Congress amended the Exchange Act to strengthen the SEC's oversight over FINRA rule-making, including its arbitration forum, to protect investors and ensure fairness. When the Court in *McMahon* held that federal securities law claims were arbitrable, 482 U.S. at 233–34, it specifically noted that the 1975 amendments gave the Commission new and "expansive power to ensure the adequacy of the arbitration procedures employed by the SROs." *Id.* at 233.

Congress most recently reaffirmed the federal policy of investor protection in the recent amendments to the Exchange Act contained in Dodd-Frank. Two provisions expressly recognize that the SEC or FINRA has the authority to regulate arbitration provisions in customers' agreements. First, Congress gave the SEC explicit authority to prohibit, or to impose conditions or limitations on the use of, "agreements 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." Exchange Act § 15(o), 15 U.S.C. § 78*o*(o) (emphasis added). The House Report supporting the bill indicates that Congress added this provision because it was concerned with "securities industry practices [that] have deprived investors of a choice when seeking dispute settlement, too. In particular, pre-dispute mandatory arbitration clauses inserted into contracts have limited the ability of defrauded investors to seek redress." 156 Cong. Rec. H5237 (daily ed. June 30, 2010) (statement of Rep. Paul Kanjorski). Thus, it is clear that the SEC can ban the use of class action waivers, at least with respect to federal securities and SRO claims. Congress, recognizing that there were grounds for concern about the use of PDAAs, authorized the SEC to protect investors from brokers' overreaching, even if this might conflict with the policies and purposes of the FAA as interpreted by the Court. Second, Congress added language to Exchange Act § 29(a), 15 U.S.C. § 78cc(a), the anti-waiver provision, to provide that "any condition, stipulation, or provision binding any person to waive compliance" *with SRO rules* "shall be void." Section 29(a), as amended, explicitly invalidates provisions in brokerage agreements that require customers to waive compliance with FINRA rules. In enacting these provisions in Dodd-Frank, Congress explicitly signaled that the securities regulators had the experience and expertise to deal with these issues consistent with investor protection, including even the power to prohibit mandatory arbitration altogether.

As demonstrated above, the Exchange Act constitutes the "contrary congressional command" that the Supreme Court requires to overcome the general mandate of the FAA to enforce arbitration agreements according to their terms.

C. The Hearing Panel Itself Recognized that FINRA Rules Can Override the FAA

The Hearing Panel's reasoning in its Decision contradicts its conclusion that only express Congressional language can override the FAA and thus cannot withstand more exacting scrutiny. FINRA Rule 2268(d)(1), which imposes conditions and limitations on the content of PDAAs, arguably conflicts with the FAA because it treats arbitration agreements differently than other contracts. *See Doctor's Associates, Inc. v. Cassarotto*, 517 U.S. 681, 684, 687 (1996) (holding a Montana state statute, which required that, to be enforceable, contracts containing an arbitration clause include notice of the clause "typed in underlined capital letters on the first page of the contract," violated the FAA because it "singl[ed] out arbitration provisions for suspect status") (quoting MONT. CODE ANN. § 27-5-114(4) (1995)). Yet the Hearing Panel held that the FAA did not bar FINRA from enforcing Rule 2268(d)(1) with respect to the language in Schwab's PDAAs that purported to take away the authority of the arbitrators to consolidate customers' claims under FINRA Rule 12312. The Hearing Panel thus recognized that FINRA, with SEC approval, can adopt rules that regulate the content of PDAAs and override the FAA. This recognition cannot be reconciled with the contrary (and incorrect) view expressed in the Decision that only explicit Congressional language can overcome the FAA's ban on "anti-arbitration" provisions.

D. The Hearing Panel's Analysis Leads to Absurd Results

Finally, if the requisite "contrary congressional command" cannot be found in specific rules resulting from a broad Congressional delegation of power, then Congress' recent creation of the Consumer Financial Protection Bureau (CFPB) (s*ee* Dodd-Frank §1011, 12 U.S.C. §§ 5491) to, *inter alia,* regulate consumer arbitration, would lead to the absurd result of unenforceable regulations under the FAA since Congress itself will not have specifically enacted those regulations. In Dodd-Frank, Congress delegated to the CFPB the explicit power to administer, enforce and implement the provisions of federal consumer financial law. *See id.* §1022(a), 12 U.S.C. § 5512. Congress further empowered the CFPB to adopt rules to "prohibit or impose conditions or limitations" on the use of pre-dispute arbitration agreements in consumer contracts if it finds that such a rule is "*in the public interest and for the protection of consumers*," *id.* §1028(b), 12 U.S.C. §5518, language that is strikingly similar to the standard for regulation set for the SEC. If the Hearing Panel's conclusion that arbitration regulations can displace the FAA only if Congress itself enacted them is upheld, Congress could no longer delegate authority to make or approve rules to administrative agencies with expertise in the area. The entire administrative law framework of our legal system would be undermined.

Like Congress' delegation of regulatory authority to the CFPB, Congress long ago delegated to the SEC the authority to oversee securities arbitration in the FINRA forum. Moreover, the Supreme Court has deferred to the regulators' expertise in previous challenges to SRO arbitration policies. *See Mastrobuono v. Shearson Lehman Hutton*, 514 U.S. 52 (1995) (upholding the power of arbitrators to award punitive damages, although the customer agreement had a New York choice of law clause and New York law at that time did not permit arbitrators to award punitive damages); *Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79 (2002) (holding that arbitration panels, and not the courts, had the power to decide whether a SRO time limitation for bringing claims had expired). In both cases, the Court supported NASD's position in the face of plausible contract arguments to the contrary.

Simply put, Congress' delegation of power to the SEC and FINRA to regulate all aspects of the broker-dealer industry, found in Exchange Act § 15A, its specific recognition of PDAAs in Exchange Act § 15(o), and its invalidation of waivers of SRO rules in Exchange Act § 29(a) displace the expression of national policy embodied in the FAA to enforce arbitration agreements in accordance with their terms. Brokerage firms should not be able to invoke the FAA to justify their removal of investors' class action remedy when FINRA rules mandate that customers have access to that remedy.

II. SINCE MCMAHON, FINRA AND THE SEC HAVE EXERCISED THEIR CONGRESSIONAL AUTHORITY TO ADOPT ARBITRATION RULES THAT PRESERVED INVESTORS' ACCESS TO COURTS FOR CLASS ACTIONS

A. Congress, the Supreme Court and the SEC Recognize the Importance of the Securities Class Action to the Integrity of the Capital Markets

Because securities fraud undermines overall confidence in the securities markets, Congress, the Supreme Court, and the SEC have acknowledged the importance of the securities fraud class action to deter fraud and to compensate investors. After the Supreme Court adopted the "fraud on the market" (FOTM) presumption of reliance in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988), in order to facilitate securities fraud class actions, business interests urged Congress to eliminate the FOTM presumption, without which federal securities class actions would be difficult, if not impossible, to maintain. The SEC opposed the elimination of the FOTM presumption,[7] and Congress decided not to eliminate it. Rather, Congress reformed the federal securities class action in the PSLRA and thus confirmed its importance to the integrity of the U.S. capital markets, H.R. Rep. No. 104-369, at 31 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730730. In 1998, Congress reaffirmed the national importance of the reformed federal securities class action when it enacted the Securities Litigation Uniform Standards Act, Pub. L. No. 105-353, 112 Stat. 3227, which preempted most class actions filed under state common law and state securities statutes. The Supreme Court recently looked to this legislative history to demonstrate that Congress reformed the federal securities class action because it "further[ed] important public-policy interests, prime among them, deterring wrongdoing and providing restitution to

[7] *Common Sense Legal Reform Act: Hearing on H.R. 10 Before the Subcomm on Telecommunications and Finance of the H. Comm. On Commerce*, 104th Cong. 203 (1995) (statement of Arthur Levitt, Chairman, Securities and Exchange Commission) (opposing proposal to eliminate the FOTM presumption both because it would be contrary to SEC's disclosure regulation and because it would make it "virtually impossible" for investors to assert claims as part of a class action).

defrauded investors." *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds,* 133 St. Ct. 1184, 1200-01 (2013).

Recently, the SEC staff reiterated its longstanding position against class action waivers in another context. In early 2012, Carlyle Group LP amended its registration statement filed with the SEC for an IPO of its limited partnership units to disclose that the Carlyle partnership agreement would require investors to arbitrate all disputes with the LP, including federal securities claims, and that (similar to the Schwab PDAA) investors may only bring claims in their individual capacities and arbitrators could not consolidate claims.[8] The SEC's Division of Corporation Finance expressed its disapproval, advising Carlyle that it "[did] not anticipate that it will exercise its delegated authority to accelerate the effective date of your registration statement if your limited partnership agreement includes such a provision…."[9] Carlyle subsequently deleted the arbitration provision.

B. FINRA and the SEC Have Adopted Arbitration Rules, Consistent with their Investor Protection Mandate, to Preserve Investors' Access to Court for Class Actions

NASD first proposed its class action rules (current FINRA Rules 12204, 2268(f)) in 1992, in response to a request from SEC Chairman David S. Ruder that the SROs consider adopting procedures that would give investors access to courts for class actions.[10] While the rule's language has been rewritten over the years, the substance of the rule has not changed. First, the NASD arbitration forum would not accept class action claims.[11] Second, the forum

---

[8] The Carlyle Group L.P., Amendment No. 2 to Form S-1 Registration Statement pursuant to the Securities Act of 1933, at 287 (Jan. 10, 2012), *available at* http://www.sec.gov/Archives/edgar/data/1527166/000095012312000638/w83442a2sv1za.htm.

[9] Letter from the SEC Div. of Corp. Fin. to Jeffrey W. Ferguson, Gen. Counsel, The Carlyle Group L.P. (Feb. 3, 2012).

[10] Proposed Rule Change by National Association of Securities Dealers, Inc., Relating to Improvements in the NASD Code of Arbitration Procedure, 57 Fed. Reg. 30519, 30520 (July 9, 1992).

[11] The SEC recently approved another FINRA proposed rule change to clarify that collective actions brought under the Fair Labor Standards Act cannot be arbitrated in the FINRA forum, in response to a judicial decision interpreting

would not permit arbitration of individual claims based on the same facts and law and involving the same defendants as in a class-certified or putative class action unless the claimant established that he was not participating in the class action. Third, the broker may not enforce any arbitration agreement against a member of a certified or putative class action until the class action was denied certification or the member was excluded or withdrew from the class. Finally, NASD amended the rule governing the content of PDAAs to require a statement prohibiting persons from bringing class actions in arbitration and from attempting to enforce an arbitration agreement against a member of a class action.

The class action rules contain three important principles: (1) investors should have the opportunity to pursue class claims in appropriate cases; (2) courts are the preferable forum for class claims because they already have in place procedures to manage class claims; and (3) firms should not be able to defeat class actions by enforcing an arbitration agreement against class members. In approving the rule, the SEC was crystal clear that:

> in all cases, class actions are better handled by the courts and that investors should have access to courts to resolve class actions efficiently. In the past, individuals who attempted to certify class actions in litigation were subject to enforcement of their separate arbitration contracts by their broker-dealers. Without access to class actions in [appropriate] cases, both investors and broker-dealers have been put to the expense of wasteful, duplicative litigation. . . .
>
> . . . *The Commission believes that investor access to the courts should be preserved for class actions. . .* [12]

FINRA Customer Code Rule 12204 to the contrary. *See* Notice of Filing of Amendment No. 1 and Order Granting Accelerated Approval of a Proposed Rule Change, as Modified by Amendment No. 1, Amending Rule 13024 of the Code of Arbitration Procedure for Industry Disputes To Preclude Collective Action Claims From Being Arbitrated, 77 Fed. Reg. 22374 (Apr. 9, 2012). This approval order reiterated two principles: collective actions belong in courts, and access to courts for class or collective action litigation should be preserved.

[12] Order Approving Proposed Rule Change Relating to the Exclusion of Class Actions from Arbitration Proceedings, 57 Fed. Reg. 52659, 52660 (Nov. 4, 1992).

C. **FINRA And The SEC Have Adopted Arbitration Rules, Consistent With Their Investor Protection Mandate, So That Broker-Dealers Cannot Use PDAAs To Take Away Customers' Rights to Bring Class Actions in Court**

FINRA and the SEC have consistently stated that brokerage agreements cannot limit investors' rights to bring class actions against broker-dealers in appropriate cases. NASD proposed the precursor of FINRA Rule 2268(d) as part of a major revision of its arbitration rules after *McMahon.* The rule was designed to improve disclosure to customers in account opening statements and to restrict the content of PDAAs. Specifically, the proposed rule prohibited broker-dealers from including in their PDAAs any provision that limited or contradicted any SRO rule (current FINRA Rule 2268(d)(1)). The SEC approved the rule because it "appropriately balanced the need to strengthen investor confidence in the arbitration systems at the SROs … with the need to maintain arbitration as a form of dispute resolution that provides for equitable and efficient administration of justice."[13] The SEC made it clear that arbitration agreements "cannot be used to curtail any rights that a party may otherwise have had in a judicial forum."[14]

In 1998, NASD proposed amendments to the rule because of concerns about customers' perceptions of unfairness.[15] The rule, as ultimately approved by the SEC in 2004, added the language set forth in FINRA 2268(d)(3) that prohibits any provision 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." The SEC approved the rule change and noted that the new language prohibiting the use of restrictive conditions "achieve[d] an appropriate

[13] Order Approving NYSE, NASD, and ASE Proposed Rule Changes relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, 54 Fed. Reg. 21,144, 21155. (May 16, 1989).
[14] *Id.* at 21154.
[15] Order Granting Approval to Proposed Rule Change as Amended and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 5 by the National Association of Securities Dealers, Inc., Regarding NASD Rule 3110(f) Governing Predispute Arbitration Agreements with Customers, 69 Fed. Reg. 70293 (Dec. 3, 2004).

balance between the interests of investors and the ability of parties to agree contractually to fair terms that would govern their disputes."[16] The SEC again stated that broker-dealer PDAAs cannot limit investors' rights and remedies.[17]

D. FINRA's Rules Do Not Reflect "Hostility" to Arbitration.

As this brief history of the FINRA rules at issue demonstrates, the Hearing Panel's decision is wrong in its conclusion that the FINRA rules reflect "the kind of 'hostility' to arbitration" prohibited by Supreme Court precedent. [Decision at 9] To the contrary, FINRA and the SEC have worked together, pursuant to their authority under the Securities Exchange Act, to provide a fair and efficient dispute resolution process that protects investors' rights so that they would have confidence in the fairness of the system. Since *McMahon,* FINRA has actively engaged in ongoing reform of its arbitration rules.[18] From 1997 to 2007, for example, NASD filed with the SEC more than sixty-five rule proposals on a variety of issues related to arbitration.[19] These proposed rule changes were the subject of extensive public comment and debate, and the broker-dealer industry was an active and vocal participant in the process. The final rules approved by the SEC as a result of this process simply cannot be described as "anti-arbitration."

In approving the FINRA rules at issue in this case, the SEC balanced the needs of the securities industry and investors in a thoughtful, informed and deliberative process that took into account comments from the industry and the public. In its review of these proposed rule changes, the SEC has consistently expressed its concerns about the fairness of the process and, in

[16] *Id*. at 70295-96.
[17] *Id.*
[18] This history is described more fully in Barbara Black & Jill I. Gross, *Making It Up As They Go Along: The Role of Law in Securities Arbitration*, 23 Cardozo L. Rev. 991, 998-1003 (2002).
[19] *See* Jill Gross, *McMahon Turns Twenty: The Regulation of Fairness in Securities Arbitration,* 76 U. Cin. L. Rev. 493, 514-517 (2008) (describing SEC's robust oversight of FINRA's arbitration process and FINRA's frequent reforms of its codes of arbitration procedure).

particular, that arbitration should not unduly restrict rights and remedies that investors would have in court. In the SEC's informed judgment, it is important for investor protection and investor confidence that customers have the ability to bring class actions against their broker-dealers in appropriate cases.

Indeed, the animus reflected in this case is Schwab's for the judicial class action. Schwab asserts that it can compel its customers to give up their right to bring class actions in court, and it challenges FINRA rules that protect investors by ensuring access to courts for class actions. If Schwab prevails, it will have accomplished what business interests lobbying Congress could not accomplish in the PSLRA: it will have succeeded in eliminating the rights of one segment of the investing public – Schwab customers -- to bring class actions in court to vindicate their rights in cases where arbitration of individual claims would not be feasible. *See Green Tree Fin. Corp.-Ala. v. Randolph*, 531 U.S. 79, 92 (2000) (recognizing in *dicta* that, if a party showed that pursuing its statutory claims through arbitration would be prohibitively expensive, and thus could not vindicate its statutory rights, a court could validly refuse to enforce a PDAA); *In re Am. Express Merchs.' Litig.*, 667 F.3d 204 (2d Cir. 2012) (voiding a class action waiver in purported class action arising under federal antitrust laws after finding that plaintiffs could not vindicate their statutory rights), *cert. granted sub nom. American Exp. Co. v. Italian Colors Restaurant*, 133 S.Ct. 594 (2012).

E. The Ability Of Customers To Bring Judicial Class Actions In Appropriate Cases Promotes Investor Protection and Fairness

The ability of brokerage customers to bring class actions in appropriate cases provides important investor protection, particularly for customers with small-value claims, who may have no effective remedy apart from a class action because of the costs of pursuing individual claims. For example, purchasers of a Schwab mutual fund, the YieldPlus Fund, brought class actions against Schwab entities, including the broker-dealer, alleging that they misrepresented the risk profile and assets of the fund and improperly changed the fund's investment policies. Plaintiffs alleged that the defendants issued, underwrote and distributed the shares in violation of federal securities and state laws. *See In re Charles Schwab Sec. Litig.*, 257 F.R.D. 534 (N.D. Cal. 2009). Because many investors had brokerage accounts with Schwab, if Schwab's prohibition on class actions had been in their PDAAs and enforced, they would have been required to arbitrate their individual claims. In approving the class action settlement, the court noted that the resolution offered "substantial recoveries" that "will provide real benefits" to the investors. *See In re Charles Schwab Sec. Litig.*, No. C08-01510 WHA, 2011 WL 1481424, at *5 (N.D. Cal. Apr. 19, 2011). The average estimated settlement payment in the federal action was $881, *id.*, an amount that would not have made individual arbitration feasible.

Other recent examples that resulted in compensation for small-value claims include class actions alleging that defendants steered customers into certain mutual funds in exchange for promotional compensation, *Bachman v. A.G. Edwards, Inc.*, 344 S.W.3d 260 (Mo. Ct. App. 2011) (affirming approval of class action settlement consisting of $26 million cash and $34 million in vouchers, that provided approximately $45 in cash and vouchers for each account); *In re American Express Financial Advisors Litigation* Order and Final Judgment (case1:04-cv-01773-DAB (S.D.N.Y. July 18, 2007) (approving $100 million settlement of five class actions).

Class actions may also allow brokerage customers to recover a greater percentage of their losses than they could obtain through individual arbitrations. For example, in *Billitteri v. Securities America, Inc.*, 2011 WL 3586217 (N.D. Tex. Aug. 4, 2011), the court approved an $80 million settlement brought by customers who purchased interests in Ponzi schemes, two insolvent entities known as Provident Royalties and Medical Capital Holdings, through

Securities America, a broker-dealer described by the court as "perilously undercapitalized." *Id.* at *11. In approving the settlement, which would provide class members with a recovery of approximately forty per cent of their losses, the court noted that the skill and zeal of the plaintiffs' attorneys resulted in a favorable settlement, considering the defendants' small amount of assets, and included a $10 million voluntary contribution from an affiliated corporation, Ameriprise.

If Schwab, and other broker-dealers, can require their customers to give up the right to bring judicial class actions such as the ones described above, loss of investor confidence in SRO securities arbitration will surely grow. Unless reversed on appeal, the Hearing Panel's Decision deals a crippling blow to the authority of FINRA and the SEC to adopt arbitration rules that balance the benefits of arbitration with the need to protect investors.

CONCLUSION

For all of the foregoing reasons, the NAC should reverse the Hearing Panel's decision that the FAA prevents FINRA from enforcing the arbitration rules at issue in this proceeding.

Dated: May 6, 2013

Respectfully submitted,

Barbara Black
Charles Hartsock Professor of Law
Director, Corporate Law Center
University of Cincinnati College of Law
P.O. Box 21140
Cincinnati, OH 45221
513-556-0113
barbara.black@uc.edu

Jill I. Gross
Professor of Law
Director of Legal Skills
Pace Universtiy School of Law
78 N. Broadway
White Plains, NY 10603
(914) 422-4061
jgross@law.pace.edu

Certificate of Service

I hereby certify that, on May 6, 2013, I caused a copy of the Motion for Leave to File Brief of Amici Professors Barbara Black and Jill Gross, and the Brief of Amici Professors Barbara Black and Jill Gross in Support of Department of Enforcement's Opening Brief to be sent by email and overnight courier to counsel for FINRA and Schwab at the addresses below:

<u>Counsel for FINRA:</u>
Thomas B. Lawson, Esq.
Daniel L. Gardner, Esq.
FINRA - Department of Enforcement
15200 Omega Drive, Third Floor
Rockville, MD 20850
thomas.lawson@finra.org
daniel.gardner@finra.org

<u>Counsel for Charles Schwab & Co.:</u>
Gilbert R. Serota, Esq.
Julian Y. Waldo, Esq.
Arnold & Porter LLP
3 Embarcadero Center, 7th Floor
San Francisco, CA 94111
gilbert.serota@aporter.com
julianwaldo@aporter.com

Jill Gross

Jill I. Gross
Professor of Law
Director of Legal Skills
Pace University School of Law
78 N. Broadway
White Plains, NY 10603
(914) 422-4061
jgross@law.pace.edu