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3rd Circ. Deepens Uncertainty Over FINRA Arbitration

By **David Cinotti** (September 25, 2018, 2:01 PM EDT)

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Customers who hire broker-dealers have a right to arbitrate disputes with them under the rules of the Financial Industry Regulatory Authority, a nonprofit authorized by federal law to oversee the broker-dealer industry. It is a trend, however, for brokerage firms to insert forum-selection clauses in customer agreements that require all disputes arising out of the brokerage relationship to be litigated in court. When the customers demand arbitration, the question arises — what controls, the FINRA rules or the customer agreements? Answering this question requires courts to consider the interplay of federal arbitration law, federal securities law and state contract law.

In Reading Health System v. Bear Stearns & Co., the U.S. Court of Appeals for the Third Circuit held that the right to arbitrate in the FINRA rules trumps a forum-selection clause in a customer agreement. The Third Circuit disagreed with prior decisions of the U.S. Court of Appeals for the Second and Ninth Circuits and agreed with the U.S. Court of Appeals for the Fourth Circuit. The Third Circuit's decision thus adds to an already existing circuit split on the relationship between FINRA rules and customer agreements.

Taken together, these decisions suggest substantial uncertainty as to the body of law that governs whether a contractual forum-selection clause in a customer agreement supersedes or waives FINRA arbitration. The Third Circuit cited its own precedent applying the presumption under the Federal Arbitration Act, or FAA, that doubts as to the scope of arbitration agreements must be resolved in favor of arbitration. It also held that waivers of FINRA arbitration should not be implied due to FINRA's role as a self-regulatory organization. It noted, but did not expressly rely on, a July 2016 regulatory notice from FINRA to its members stating that customer agreements cannot waive the right to arbitrate. The Second Circuit and the Ninth Circuit (in a 2-1 decision) rejected application of the federal presumption, did not rely on the regulatory nature of the FINRA rules, and held that the customer agreements waived the right to arbitrate based on the plain language of those agreements. The Fourth Circuit also did not apply the arbitrability presumption or find that there was any federal preemption. Unlike the Second and Ninth Circuits, however, the Fourth Circuit held that the forum-selection clause did not foreclose arbitration, as interpreted under applicable state contract law.

Although circuit splits are often precursors to U.S. Supreme Court review, that review might be premature in this area because the lower courts have not fully explored the effect of FINRA's July 2016 regulatory notice on the enforceability of customer agreements that purportedly waive FINRA

arbitration. FINRA has said that its rules do not permit arbitration waivers, and the Securities Exchange Act invalidates contracts that are inconsistent with a self-regulatory organization's rules. It would therefore appear that federal securities law, not federal arbitration law or state contract law, governs the relationship between the FINRA rules on arbitration and forum-selection clauses calling for litigation. Only the Third Circuit had the FINRA regulatory notice before it, but it declined to resolve the case on preemption grounds.

Case Background

From 2003 to 2007, Reading Health issued auction-rate securities (known as ARS) to finance capital projects at some of its hospitals. Bear Stearns, which J.P. Morgan later acquired, was the underwriter and broker-dealer on the offerings. An ARS is a medium- to long-term debt security that is sold through what is known as a Dutch auction, in which the price of the offering is established periodically based on bids. Reading Health claimed that Bear Stearns and other broker-dealers conspired to create a false impression of market demand for ARSs; the market collapsed when they allegedly stopped propping it up. As a broker-dealer, Bear Stearns, and its successor J.P. Morgan, were required to be FINRA members. FINRA Rule 12200 obligates members to arbitrate customer disputes upon a customer's demand for arbitration. But Reading Health and Bear Stearns also entered into customer agreements that required "all actions and proceedings arising out of" the customer agreements "or any of the transactions contemplated" by them to be litigated in the U.S. District Court for the Southern District of New York.

In 2014, Reading Health commenced arbitration with FINRA, but J.P. Morgan maintained that the dispute had to be litigated in New York. In 2015, Reading Health filed an action for a declaratory judgment in the U.S. District Court for the Eastern District of Pennsylvania and then moved to compel J.P. Morgan to arbitrate. J.P. Morgan moved to transfer the action to the Southern District of New York and, in the alternative, to enjoin the FINRA arbitration. The district court denied the motion to transfer and granted Reading Health's motion to compel arbitration. After permitting J.P. Morgan to file an interlocutory appeal, the Third Circuit affirmed.

The Third Circuit's Decision

The Third Circuit resolved three issues in its decision: (1) whether Reading Health's motion to compel arbitration or J.P. Morgan's motion to transfer venue should be decided first, (2) whether the forum-selection clause required that the Southern District of New York decide the motion to compel arbitration, and (3) whether the forum-selection clause in the customer agreements overrode the FINRA rules.

On the first and second issues, the court concluded that the arbitrability of the dispute should only be decided after resolving the threshold matter of venue — whether the Eastern District of Pennsylvania or the Southern District of New York was the proper forum to hear the motion to compel arbitration. The Third Circuit then held that the forum-selection clause in the customer agreements did not require transfer to the Southern District of New York because Reading Health's action for a declaratory judgment that the dispute was arbitrable did not fall under the language of the forum-selection clause. The third issue — the primary concern of this article — was whether the customer agreements trumped or waived Reading Health's right to arbitrate under the FINRA rules. As the Third Circuit noted, other circuit courts previously addressed that issue and reached different conclusions. The Second and Ninth Circuits held that a customer agreement calling for all actions or proceedings arising out of the agreement to be litigated controlled over the FINRA rules, and thus broker-customer disputes had to be

litigated, not arbitrated. The Fourth Circuit, in contrast, held that the customer agreements did not act as a waiver of a customer's right to FINRA arbitration.

The Third Circuit agreed with the Fourth Circuit. It reasoned that a waiver must be knowing before it is effective and that settled federal law required any doubts as to whether a dispute is arbitrable to be resolved in favor of arbitration. In addition, the court was "reluctant to find an implied waiver [because] Reading's right to arbitrate is not contractual in nature, but rather arises out of a binding, regulatory rule that has been adopted by FINRA and approved by the [U.S. Securities and Exchange Commission]." The court was concerned that finding an implicit waiver of arbitration would "erode investors' ability to use an efficient and cost-effective means of resolving allegations of misconduct in the brokerage industry and thus undermine FINRA's ability to regulate, oversee, and remedy any such misconduct."

Analysis

The ultimate issue in these cases is one of "arbitrability," a loosely defined category that includes "whether the parties have agreed to arbitrate or whether their agreement covers a particular controversy." All of the circuits agreed, either explicitly or implicitly, that the courts had to decide whether the dispute between the customers and their brokers was arbitrable. But they were not entirely clear as to which body of law governed the effect of the customer agreements on the FINRA rules — federal arbitration law, federal securities law or state contract law.

Federal Arbitration Law

The FAA "create[s] a body of federal substantive law of arbitrability, applicable to any arbitration agreement within the coverage of the Act." Among the federal substantive principles is the rule that "any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability." That presumption applies when the scope of the parties' agreement to arbitrate is ambiguous, not when the existence of a valid arbitration agreement is in doubt.

In Reading Health, the Third Circuit cited its prior case law holding that the presumption of arbitrability applied in similar cases, supporting its conclusion that the customer agreements did not supersede the FINRA rules. The Fourth Circuit also held that the FINRA rules controlled, but it did not rely on the presumption of arbitrability. The Second and Ninth Circuits held that the presumption of arbitrability did not apply because the question was whether there existed an arbitration agreement between the parties, not the scope of an ambiguous arbitration clause.

It does not appear that the presumption of arbitrability comes into play in these cases. Although the Supreme Court has said that the presumption governs when the question is whether a party has waived the right to arbitrate, it has also more recently held that the presumption of arbitrability only controls as an interpretative tool for party intent when an arbitration clause is ambiguous as to whether a particular dispute falls within its scope. As the Supreme Court explained, the presumption is part of a policy to overrule the historical judicial hostility to arbitration, but it only applies "where it reflects ... a judicial conclusion that arbitration of a particular dispute is what the parties intended because their express agreement to arbitrate was validly formed and (absent a provision clearly and validly committing such issues to an arbitrator) is legally enforceable and best construed to encompass the dispute."

The dispute in Reading Health and the other cases was over the existence of an enforceable arbitration agreement (by way of the FINRA rules) between the parties, not whether the FINRA rules encompassed

the customers' claims (they undisputedly did). Accordingly, Supreme Court precedent suggests that the federal presumption of arbitrability does not impact whether a customer agreement supersedes the right to FINRA arbitration.

Federal Securities Law

Federal securities law, on the other hand, does appear to have a direct effect on the analysis in these cases. FINRA is a self-regulatory organization formed under federal securities law, whose rules the SEC approves and which has "the authority to exercise comprehensive oversight over 'all securities firms that do business with the public.'" In July 2016, FINRA issued a regulatory notice to its members stating: "FINRA reminds member firms that customers have a right to request arbitration at FINRA's arbitration forum at any time and do not forfeit that right under FINRA rules by signing any agreement with a forum selection provision specifying another dispute resolution process or an arbitration venue other than the FINRA arbitration forum." Under the Securities Exchange Act of 1934, "[a]ny condition, stipulation, or provision binding any person to waive compliance with ... any rule of a self-regulatory organization, shall be void."

Of the four circuits, only the Third Circuit had the benefit of FINRA's regulatory notice at the time it issued its opinion. The Third Circuit cited the regulatory notice but said that it did not need to address whether the notice rendered unenforceable a forum-selection clause that waived the right to arbitrate. A full discussion of whether courts should defer to FINRA's interpretation of its own rules is beyond the scope of this article, but there would appear to be a strong argument that the forum-selection clauses are purported waivers of FINRA arbitration that are not permitted under the Securities Exchange Act. If that is correct, federal securities law would preempt state contract law, even assuming that the forum-selection clauses acted as a waiver of, or superseded, the FINRA rules under state law.

State Contract Law

Without the presumption of arbitrability or preemption from federal securities law, whether customer agreements waive or supersede the right to arbitrate becomes, in the Fourth Circuit's words, "a straightforward issue of contract interpretation" to be resolved under the state contract law selected in the customer agreements or that otherwise applies under choice-of-law rules. The Third Circuit did not apply the law selected in the customer agreements at issue because it found that the parties waived choice-of-law issues. The Second, Fourth and Ninth Circuits all applied state contract law but reached different results in the interpretation of the same or similar contractual language.

If no federal principles are involved, the federal courts' interpretation of the forum-selection clauses are simply the views of federal courts applying state law. State courts addressing the same contractual language would be free to disagree, and whether customer agreements trump the FINRA rules could vary based on the language of the agreements and which state law applies.

Conclusion

In sum, federal securities law, rather than federal arbitration or state contract law, may ultimately resolve whether customers have an enforceable right to arbitrate disputes with their broker-dealers despite a contractual forum-selection clause calling for litigation. Because the circuit courts have not fully addressed that issue, Supreme Court review to resolve the existing circuit split may be premature.

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