

FINRA Securities Class Action Arbitrations: An Idea Whose Time Has Not Yet Come -- and Likely Never Will

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INTRODUCTION

Ever since the Supreme Court ruled that class action arbitration was legally viable under the Federal Arbitration Act (“FAA”) in 2003, there has been a surge in class-wide arbitrations at leading arbitration forums throughout the country, particularly for consumer-related disputes. As more and more businesses include mandatory arbitration provisions in consumer contracts, the movement toward class action arbitration seems likely to grow. This growth has occurred despite the increasing tendency to include class action waivers in arbitration agreements, and the split among courts as to whether such waivers are enforceable. One important area that has been untouched by this trend, however, is securities arbitration.

While the American Arbitration Association (“AAA”), for example, has had class arbitration rules in effect for several years, the Financial Industry Regulatory Authority (“FINRA”), the largest securities regulatory organization in the country, and FINRA Dispute Resolution, the largest securities arbitration forum, explicitly excludes class action arbitration in its Code of Arbitration Procedure (“FINRA Code” or “the Code”).

Are arbitrations and class actions so diametrically opposed that FINRA has wisely decided it would be a mistake to permit class action arbitrations? Is there any indication that FINRA will depart from its long-standing ban on class action arbitrations in the future, particularly when, for many individual customers, recent investment scandals like the collapse of the auction-rate securities market and Bernard Madoff’s \$50 billion Ponzi scheme seem almost ideally suited for class-wide arbitrations? More important, should FINRA once again revise the Code and enact new rules that will not only permit class action arbitrations, but establish the necessary policies and procedures to ensure their success?

This paper argues that FINRA should stay the course and explains why securities class action arbitrations are both improper and impractical. By highlighting the difficulties that class action arbitrations would pose for FINRA, it explains why the Code’s exclusion of class actions from arbitration is more appropriate than ever and should be continued.¹

¹ For an opposite viewpoint, see Matthew Eisler, *Difficult, Duplicative and Wasteful?: The NASD’s Prohibition of Class Action Arbitration in the Post-Bazzle Era*, 28 Cardozo L. Rev. 1891 (2007) (“the NASD should provide an arbitral forum for the resolution of class action claims, as it does for virtually all other disputes.”).

FINRA's Long-Standing Exclusion of Class Action Arbitrations.

FINRA, a self-regulatory organization (“SRO”) registered under the Securities Exchange Act of 1934, is the result of the July 2007 merger between the National Association of Securities Dealers (“NASD”) and the New York Stock Exchange. FINRA operates the nation’s largest arbitration forum for the resolution of disputes between customers and member firms as well as between brokerage firm employees and their firms.²

Since 1992, the FINRA Code has declined to recognize class action arbitration as a permissible option for either customers or industry members.³ Indeed, Rules 12204(a) and 13204(a) of the Code expressly prohibit the arbitration of class action claims for customer and industry disputes, respectively. As the SEC order approving the exclusion of class arbitrations from NASD arbitration proceedings stated nearly 17 years ago, “the judicial system has already developed the procedures to manage class action claims. Entertaining such claims through arbitration at the NASD would be difficult, duplicative and wasteful.”⁴

Although the securities industry has changed dramatically since then, the ban against class action arbitrations at FINRA has persisted.

The FAA and Class Action Arbitrations

The FAA, 9 U.S.C. §§ 1-14, is silent on whether class action claims may be pursued in arbitration, and it was not until the Supreme Court’s decision in *Green Tree Financial Corp. v. Bazzle*, 539 U.S. 444 (2003), that the confusion pervading the lower courts over this issue was finally resolved.⁵ In *Bazzle*, the Court made two important rulings. First,

² The American Stock Exchange (“AMEX”), the Chicago Board Options Exchange (“CBOE”), the Municipal Securities Rulemaking Board (“MSRB”) and the American Arbitration Association (“AAA”) also sponsor securities arbitration proceedings. As SROs, FINRA, AMEX, CBOE and the MSRB are members of the Securities Industry Conference on Arbitration (“SICA”) and regulated by the Securities and Exchange Commission (“SEC”). Since the AAA is not an SRO, it is neither affiliated with SICA nor subject to SEC oversight.

³ Rule 13204(a) likewise prohibits class action claims for industry disputes. There is no substantive difference between the former NASD Code of Arbitration Procedure and the FINRA Code, which applies to claims filed on or after April 16, 2007.

⁴ S.E.C. Release No. 34-31371, 52 S.E.C. Docket 2189, 1992 WL 324491 (Oct. 28, 1992).

⁵ The confusion was exacerbated by the fact that, while the FAA requires courts to enforce arbitration agreements according to their terms, until recently, most agreements offered no guidance as to whether class arbitration was contemplated by the parties. The result was that while some courts interpreted the silence narrowly and thus found that the agreement precluded class arbitrations, others took a broader view and held that arbitration of class action claims should be allowed. See *Champ v. Siegel Trading Co., Inc.*, 55 F.3d 269, 275 (7th Cir. 1995) and *Gammareo v. Thorp Consumer Disc. Co.*, 828 F. Supp. 673, 674 (D. Minn. 1993) (class arbitrations not permitted), and contrast with *Dickler v. Shearson Lehman Hutton, Inc.*, 596 A.2d 860 (Pa. Super. Ct. 1991) (class arbitration allowed).

the Court held that class arbitrations are permissible under the FAA, even when the pre-dispute arbitration agreement itself fails to address the issue. Second, the Court concluded that arbitrators, rather than judges, should interpret the agreement in order to determine whether arbitration of class claims is possible. In other words, if an arbitration agreement is silent regarding class actions, it is up to the arbitrator (applying state law) to decide whether class arbitration will proceed.

Following the Supreme Court's *Bazzle* decision in 2003, the AAA enacted "Supplementary Rules for Class Arbitrations" as did other arbitration forums.⁶ The NASD (now FINRA), however, continued its prohibition of class action arbitrations.

Many companies with consumer adhesion contracts (credit cards, bank accounts, securities brokerage accounts, mobile phones, car rentals, and cable services, among many others) routinely include mandatory arbitration provisions in their customer agreements. Since *Bazzle*, however, these agreements increasingly include express waivers of the right to arbitrate class actions.⁷

Despite the FAA's mandate to enforce an arbitration agreement according to its terms,⁸ many courts have found these waivers unconscionable and unenforceable under state law.⁹ Most recently, *In re American Express Merchants' Litigation*, No. 06-1871 (2d Cir. Jan. 30, 2009), the Second Circuit struck down an arbitration clause that banned any type of class or representative litigation. The court's ruling was based on its conclusion that the ban would have effectively altered the substantive law by making the plaintiffs'

⁶ In addition to the AAA, other arbitration forums – the National Arbitration Forum ("NAF") and JAMS The Resolution Experts ("JAMS") – also have procedures in place to deal with class action arbitrations. After submission of a class action, the AAA, NAF and JAMS each divide the arbitration process into three stages: (1) determination by the arbitrator as to whether the arbitration clause permits class arbitration; (2) class certification by the arbitrator; and (3) decision on the merits by the arbitrator. The AAA permits an immediate court appeal of an arbitrator's decision that the arbitration clause permits class arbitration, while JAMS leaves the issue to the arbitrator's discretion. A JAMS arbitrator may make a clause construction decision that would be immediately appealable, or may simply withhold the decision, thus delaying any appeal until the proceeding is completed. NAF provides no mechanism to appeal the arbitrator's decision regarding the construction of the arbitration clause, including whether it envisioned class action arbitration.

⁷ Since the FINRA Code expressly excludes class action arbitrations, there is no need for the customer agreements of securities firms to include waivers of the right to arbitrate class actions. The vast majority (both customer and industry disputes) of securities arbitration claims are conducted under the auspices of FINRA.

⁸ Section 4 of the FAA provides that "A party aggrieved by the alleged failure, neglect or refusal of another to arbitrate under a written agreement for arbitration may petition any United States district court . . . for an order directing that such arbitration proceed in the manner provided for in such agreement. . . . The court shall hear the parties, and upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement." 9 U.S.C. § 4.

⁹ See, e.g., *Skirchak v. Dynamics Research Corp.*, 500 F.3d 49 (1st Cir. 2007); *Dale v. Comcast Corp.*, 498 F.3d 1216 (11th Cir. 2007); *Rollins, Inc. v. Garrett*, 176 Fed. Appx. 968 (11th Cir. 2006).

federal antitrust claims impossible to vindicate. The Second Circuit also relied heavily on the plaintiffs' expert affidavit, which established that litigating such a complex case on an individual basis would be far more costly than the value of any individual's claim.

Other courts, however, have taken the opposite approach and upheld agreements containing waivers of the right to arbitrate class actions, regardless of the fact that doing so effectively prevents plaintiffs from pursuing their claims.¹⁰ In *Litman v. Cellco Partnership*, No. 07-CV-4886, 2008 WL 4507573 (D.N.J. Sept. 29, 2008), for example, the district court ruled that the FAA preempts a New Jersey Supreme Court decision holding that a class waiver, if it functions as an exculpatory clause, renders an arbitration agreement unconscionable and therefore unenforceable under New Jersey law. The class waiver at issue in *Litman* barred class-wide arbitration and required arbitration on an individual basis. Although the *Litman* court acknowledged that its holding would effectively end the Verizon Wireless customer's claim, the court held that any change to the FAA's preemptive power must come from Congress, not the judiciary.

Complexity of Class Actions Under the Federal Rules of Civil Procedure

An enormous body of rules and procedures has evolved over the years to deal with the complexity and challenges of class actions, which are, by their very nature, unique creatures of law. As such, class actions are antithetical to the very foundations of FINRA securities arbitration, as well as to the principles and procedural norms that have developed and evolved over the years.

Rule 23 of the Federal Rules of Civil Procedure provides the procedural rules and requirements for class actions to proceed in federal court and similar rules have been adopted by most states as well.

Under Rule 23(a), before one or more members of a class may sue as representative parties on behalf of all members, the following prerequisites must be met: "(1) the class must be so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class; and (4) the representative parties will fairly and adequately protect the interests of the class." Fed. R. Civ. P. 23(a).

The due process clause of the Constitution and Rule 23(c)(2) both require that all identifiable members of a class receive individual notice of a proposed class action. The court must also consider "the desirability or undesirability of concentrating the litigation of the claims in the particular forum" and "the likely difficulties in managing a class action." Fed. R. Civ. P. 23(b)(3)(C) and (D).

¹⁰See, e.g. *Caley v. Gulfstream Aerospace Corp.*, 428 F.3d 1359 (11th Cir. 2005); *JLM Industries, Inc. v. Stolt-Nielson SA*, 387 F.3d 163 (2d Cir. 2004); *Carter v. Countrywide Credit Indus., Inc.*, 362 F.3d 294 (5th Cir. 2004).

Class Action Arbitrations Would Require FINRA's Code To Be Completely Rewritten.

Class action arbitrations at FINRA would be unreasonable and impractical for many reasons, perhaps foremost of which is the fact that the Code would require an entirely new set of rules¹¹

A. Many Arbitrators Lack the Legal Training, Background and Expertise Needed to Address the Complex Issues Inherent in Class Action Arbitrations.

Although FINRA's roster of public and non-public or industry arbitrators includes lawyers, bankers and other professionals, for the most part they would be ill-equipped and ill-prepared to deal with the myriad of complex issues they would be expected to rule upon in class action arbitrations. Furthermore, FINRA arbitrators are trained to decide cases on a fair and equitable basis based on industry custom and practice, not necessarily the letter of the law.

As every experienced securities arbitration practitioner knows, selecting the Panel who will decide your case is critical. Although FINRA has a roster of over 6,600 arbitrators (2,868 industry or non-public and 3,739 public)¹² available to hear arbitration claims throughout the country, many have no legal training or expertise. The simple truth is that relatively few arbitrators have the training necessary to try class actions.

The preliminary issues that arbitrators would be required to decide in class action arbitrations could easily prove overwhelming. For example, class actions require that fundamental facts be determined before a class is certified. A class action is appropriate only when the alleged wrongdoing arises from a set of facts and issues common to class members and which predominate over individual issues. Arbitrators would thus be required to rule on many threshold issues including, but not limited to, the following:

1. Whether the individual bringing the class arbitration, i.e., the lead claimant, is an appropriate representative of the class;
2. Whether the attorney representing the lead plaintiff is appropriate and has the capability of handling a large case;
3. Whether there are common elements of law and fact that make the claim suitable for class action arbitration;
4. Whether the members of the class are so numerous that class arbitration is appropriate.

¹¹Although FINRA may revise the FINRA Code at any time, as a registered SRO, any proposed rule change is subject to the SEC's approval. 15 U.S.C. § 78s-(b)(1).

¹²See FINRA Dispute Resolution Statistics, Summary Arbitration Statistics December 2008, <http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/index.htm>.

These decisions would all be preliminary to the certification of a class action arbitration. Because these binding decisions that affects whether or not the case goes forward, they must be determined by someone trained in the law. Many FINRA arbitrators do not have legal or judicial training or credentials.

B. Class Actions Are Contrary to the Purpose of Arbitration.

Among the many reasons why class action arbitrations would be inappropriate for FINRA arbitration are the following:

1. Class action arbitrations would be contrary to arbitration's policy goal of resolving disputes promptly and economically. Under the FINRA Code, arbitration is quick, easy and relatively inexpensive. Arbitration class actions would be long, complicated and costly. Even in complicated cases, hearing sessions rarely go beyond several weeks. According to FINRA statistics, the average length of an arbitration proceeding from filing the Statement of Claim to the final hearing ranges between 12 and 18 months. Class actions typically take years to resolve or settle, if they do, immediately prior to trial. Arbitration class actions would almost certainly involve months of hearings.

In view of the many motions and procedural issues that arbitrators would be forced to decide, just as class actions in court frequently take years before reaching trial or settlement, resolution of class action arbitrations would far exceed the 12 to 18 months that parties typically experience in individual arbitrations. In short, class action arbitrations would be much more time-consuming.

Discovery is limited and depositions are rare in FINRA arbitrations. The time and costs expended to obtain an award have been streamlined and significantly reduced. These timeliness advantages would be lost in a class action arbitration. Since many arbitrators also are employed full-time, it would be difficult, if not impossible, to select qualified arbitrators willing to put their lives and careers on hold for many months of hearings.

2. Class actions are full of motions and discovery is complicated. Unlike FINRA arbitrations, which provide for limited discovery and authorize depositions only when exigent or other extraordinary circumstances warrant, discovery in class actions typically involves thousands of documents and dozens of depositions, if not more. These are not commonplace in arbitration. While Rule 12504 of the FINRA Code permits dispositive motions such as motions to dismiss, they are strongly disfavored as are other motions. In contrast, class actions contain a great variety of motion practice.

3. Arbitration awards are not reasoned opinions, yet class action arbitration awards could easily affect tens or hundreds of thousands of individuals. Fairness suggests that a decision impacting so many persons calls for a reasoned decision. On February 4, 2009, the SEC approved a new FINRA rule that will require arbitrators to provide a written explanation of an award or "explained decision," if both parties in the case request one. It seems highly improbable, however, that both parties in a case would agree on the need for an explained decision.

C. The Extensive Motion Practice Inherent in Class Actions Is Inappropriate and Impractical in Arbitration.

Class actions revolve around rulings on multiple motions - motions to dismiss, motions to certify, motions for lead plaintiff, motions for summary judgment, among many others. Although FINRA arbitrators receive \$200 per hearing session, or \$400 per day, they receive no compensation for reading lengthy briefs and other materials submitted by the parties in support of or in opposition to the motion prior to the hearing on the motion. It is unrealistic and unfair to expect arbitrators to spend hours wading through lengthy and complicated legal briefs prior to the hearing session. Furthermore, in its arbitrator education and training materials, FINRA discourages arbitrators from conducting any independent legal research unless they have so advised the parties. Federal and state judges hearing motions in class actions have law clerks and others to assist them with legal research.

D. Class Action Arbitrations Would Pose Enormous Procedural and Administrative Problems for FINRA.

A class action arbitration would require at least one massive mailing to inform all class members that the class has been certified. Responses to the class certification notices would also require personnel to review and file them. Who at FINRA would be responsible for the enormous amount of time, effort and resources necessary to accomplish these administrative tasks?

FINRA is funded primarily by assessment of member firms' registered representative and applicants, annual fees paid by members and by fines that it levies. The annual fee that each member pays includes a basic membership fee, an assessment based on gross income, a fee for each principal and registered representative and charge for each branch office. Since FINRA is funded by the securities industry, in light of the crisis facing it today, it seems unlikely that additional funds would be available to hire the personnel needed to perform these duties. Furthermore, how would filing fees be determined and how much would a class representative be required to pay to file a class action arbitration?

E. Class Action Arbitrations Would Involve Claims for High Damages Awards.

While multimillion dollar awards in the \$2 million to \$5 million range are not unusual in FINRA arbitrations, they are far from typical, especially in customer-related claims. Indeed, until a New York arbitration panel recently ordered Credit Suisse Securities to pay an electronics firm more than \$400 million in damages in an auction-rate securities case¹³, only a handful of customer awards have exceeded \$20 million. In contrast, settlements and verdicts in the hundreds of millions of dollars are often the

¹³See the FINRA arbitration award in *STMicroelectronics N.V. v. Credit Suisse Securities (USA) LLC*, Case No. 08-00512 (Feb. 12, 2009). The total award was \$431.8 million, which included \$25.2 million in interest already paid and more than \$6.5 million in fees.

norm in securities class action lawsuits. Class action awards, in contrast, are typically huge.

F. Class Action Arbitrations Would Require FINRA to Hire Additional Staff.

An already over-burdened FINRA staff would find it difficult, if not impossible, to cope with the demands and administrative burdens that class action arbitrations would necessarily entail. According to FINRA, nearly 5,000 arbitration cases were filed in 2008, an increase of 54% from the previous year.¹⁴ This significant increase is obviously the result of turmoil in the markets, driven by declines in investments tied to subprime mortgages, the collapse of the auction-rate securities market and the ensuing dramatic decline in values. Since as of early 2009 there is little evidence that the credit crisis is abating – on the contrary, there are troubling signs that it is worsening – the likelihood is that FINRA can expect even more arbitration claims to be filed this year and in 2010, if not beyond then.

Furthermore, it is almost certain that Bernard Madoff's \$50 billion Ponzi scheme will result in a new surge of arbitration cases filed with FINRA. Attorneys representing customers of feeder funds that invested with Madoff are seeking to recover losses from any solvent party. FINRA member firms and registered representatives who purchased or sold these funds are likely to be named as respondents in arbitration cases. 2009 and 2010 may well be record years for the number of arbitration claims filed with FINRA.

As any experienced securities arbitration practitioner knows all too well, FINRA's intake personnel, case managers, and other administrative staff already appear to be having difficulty dealing with the increased number of new cases. FINRA case managers and staff in the regional offices are often helpful and accommodating to attorneys for both claimants and respondents, and typically make every effort to ensure that arbitration cases proceed smoothly through the system. They attempt to send arbitrator lists to the parties, schedule telephone conferences and hearings, assign hearing venues, respond to questions, and handle a myriad of other administrative tasks in a timely manner. Despite their best efforts, however, it is clear that they are overburdened and understaffed. Class action arbitrations would require FINRA to add many more staff and administrative personnel. With many member firms on the brink of collapse and requiring government bailouts, where would the funding for these additions come from?

CONCLUSION

It is highly unlikely that FINRA will amend the Code to permit class actions in arbitration anytime soon, and that is the way it should be. The exclusionary rule is as important and relevant today as it was when first enacted in 1992.

¹⁴See FINRA Dispute Resolution Statistics, Summary Arbitration Statistics December 2008, <http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/index.htm>.

Simply stated, let securities arbitration be securities arbitration - the relatively quick, easy and inexpensive way to resolve disputes, and let class actions be class actions. Let's not complicate an arbitration process that works well by attempting to recreate and duplicate the policies and procedural safeguards for class actions that federal courts have developed over many years.

Let's keep in mind instead the quotation that serves as the introduction to The Arbitrator's Manual:

Equity is justice in that it goes beyond the written law. And it is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas the judge looks only to the law, and the reason why arbitrators were appointed was that equity might prevail.

Domke on Aristotle, The Arbitrator's Manual (Aug. 2007).