FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. CHARLES SCHWAB & COMPANY, INC. (CRD No. 5393), Respondent.	Disciplinary Proceeding No. 2011029760201 Hearing Officer—LOM **HEARING PANEL DECISION GRANTING IN PART AND DENYING IN PART THE PARTIES' CROSS-MOTIONS FOR SUMMARY DISPOSITION** February 21, 2013

The first two causes of action in this disciplinary proceeding against Respondent, Charles Schwab & Company, Inc., charge that new provisions in Respondent's customer agreements by which a customer waives any ability to assert a claim by means of a judicial class action conflict with and violate FINRA Rules 2268(d)(1) and (d)(3) and NASD Rules 3110(f)(4)(A) and (4)(C). These Rules operate to preserve judicial class actions as an alternative to arbitration, even when there is a pre-dispute arbitration agreement between a FINRA member firm and its customer. The Hearing Panel concludes that Respondent's new language does conflict with and violate these Rules. The Hearing Panel further concludes, however, that these Rules may not be enforced. Enforcement is foreclosed by the Federal Arbitration Act, as construed by the Supreme Court in *Concepcion* and other decisions. Those decisions hold that adjudicators must enforce agreements to go to arbitration to resolve disputes and must reject any public policy exception that disfavors arbitration, unless Congress itself has indicated an exception to the Act. Accordingly, the Hearing Panel dismisses the first two causes of action.

The third cause of action charges that other new language in Respondent's customer agreements requiring customers to agree that arbitrators have no power to consolidate more than one party's claims in arbitration violates FINRA Rule 2268(d)(1) and NASD Rule 3110(f)(4)(A) by attempting to "limit" and "contradict" FINRA Arbitration Rule 12312. FINRA Arbitration Rule 12312 specifies circumstances in which arbitrators may arbitrate consolidated claims. The Hearing Panel concludes that the new language purporting to limit the powers of FINRA arbitrators violates FINRA Rule 2268(d)(1) and NASD Rule 3110(f)(4)(A) in two respects: (i) the consolidation language undermines the fundamental operation of Rule 12312

and, in fact, the overall operation of FINRA Arbitration Rules generally, by depriving FINRA of its authority to grant and circumscribe the powers of arbitrators in FINRA's forum; and (ii) the consolidation language contravenes the specific authority given to the arbitrators to join individual claims in specified circumstances. The Hearing Panel further concludes that the Federal Arbitration Act does not bar enforcement of these Rules, because the Act does not dictate how an arbitration forum should be governed and operated or prohibit the consolidation of individual claims.

In each cause of action, Enforcement also alleged that, by virtue of the other alleged Rule violations, Schwab violated FINRA Rule 2010. The Hearing Panel concludes that by virtue of the violation found in the third cause of action, Respondent also violated FINRA Rule 2010.

For the violations found as to the third cause of action (NASD Rule 3110(f)(4)(A) and FINRA Rules 2268(d)(1) and 2010), Respondent is ordered to take corrective action, which includes removing the violative language from customer agreements, and sending promptly to all customers whose customer agreements were amended or created with the violative language a notice indicating that the prior limitation on the powers of FINRA arbitrators is not effective. The notice should reiterate that Schwab agrees to arbitrate in accord with FINRA Arbitration Rules, as amended from time to time, and indicate that consolidation is available in arbitration pursuant to those Rules. In addition, Respondent is ordered to pay a fine of $500,000 and the hearing costs.

I. INTRODUCTION AND PROCEDURAL STATUS OF THE CASE

The Financial Industry Regulatory Authority, Inc. ("FINRA") Department of Enforcement ("Enforcement") brought this disciplinary action against Respondent, Charles Schwab & Company, Inc. ("Schwab" or "Respondent")[1] challenging the enforceability of new provisions in Schwab's customer account agreements relating to the arbitration of customer claims. Those new provisions are found in Schwab's pre-dispute arbitration agreements with

[1] FINRA, which is responsible for regulatory oversight of securities firms and associated persons who do business with the public, was formed in July 2007 by the consolidation of NASD and the regulatory arm of the New York Stock Exchange ("NYSE"). FINRA is developing a new "Consolidated Rulebook" of FINRA Rules that includes NASD Rules. The first phase of the new consolidated rules became effective on December 15, 2008. *See* FINRA Regulatory Notice 08-57 (Oct. 2008). Because the Complaint in this case was filed after December 15, 2008, FINRA's Procedural Rules apply to the proceeding. The applicable FINRA and NASD Conduct Rules are those that existed when the conduct in issue occurred. FINRA's Rules (including NASD Rules) are available at www.finra.org/Rules. References here to FINRA include NASD.

customers under the heading "Waiver of Class Action or Representative Action" ("Waiver"). The Waiver would, in effect, require any customer claim against Schwab to be arbitrated and to be arbitrated solely on an individual, case-by-case basis.

The Complaint was filed on February 1, 2012. It states three causes of action, but only two aspects of the new provisions are in issue.

First, Schwab's Waiver imposes an agreement that customers "waive any right to bring a class action, or any type of representative action" against Schwab or any related third party "in court." This new language would eliminate judicial class actions. As a result, all customer claims would go to arbitration, without exception; and, because FINRA Arbitration Rules separately prohibit class actions in arbitration, the new language also would have the effect of barring any class actions against Schwab in any forum. The issue is whether the elimination of judicial class actions violates FINRA Rules that operate to preserve a customer's option to participate in a judicial class action, even when a FINRA member's customer agreement contains a pre-dispute agreement to arbitrate (Causes One and Two).

Second, Schwab's Waiver also imposes on customers an agreement that "the arbitrator(s) shall have no authority to consolidate more than one parties' [sic] claims" in arbitration. This new language would deprive FINRA arbitrators of any authority to join or consolidate individual claims in arbitration by requiring a Schwab customer to agree that an arbitrator shall have no such power.[2] The issue here is two-fold: (i) whether this language violates FINRA Rules that give FINRA the authority to determine the powers of its arbitrators by promulgating Rules granting and circumscribing the arbitrators' powers, and, (ii) more specifically, whether this language violates FINRA Rules that expressly provide for consolidation of individual claims and

[2] The new provisions also bind Schwab to assert any claim against the customer as an individual claim in arbitration, but that aspect of the agreement is not in issue.

give arbitrator panels final authority as to whether to go forward on a consolidated basis (Cause Three).

The Parties agree that the material facts regarding the alleged violations are not in dispute, and each Party contends that it is entitled to summary disposition based on those facts as a matter of law.[3] On May 30, 2012, the Hearing Panel held a non-evidentiary hearing and heard oral argument on the motions for summary disposition. That oral argument primarily focused on whether Schwab had committed any violation in connection with its new Waiver. On August 28, 2012, the Hearing Officer issued an Order informing the Parties that the Hearing Panel had determined to dismiss the first two Causes of Action but to find a violation with respect to the third Cause of Action. Pursuant to a later scheduling Order, the Parties then submitted briefs in

[3] The Parties filed a joint stipulation of undisputed facts on May 2, 2012, and opposing motions for summary disposition on May 4, 2012. Each Party supported its motion with exhibits and provided an additional statement of undisputed facts. Each Party filed an opposition to the other's motion on May 16, 2012. The Parties also filed reply briefs in support of their own motions on May 25, 2012.

The following abbreviations are used here for those initial filings:

(1) Joint Stipulation Of Undisputed Facts For Motions For Summary Disposition ("Jt. Stip.");

(2) Enforcement's submissions:
   a. Department of Enforcement's Motion for Summary Disposition and Department of Enforcement's Memorandum Of Points And Authorities In Support Of Its Motion For Summary Disposition (together, "Enf. Motion");
   b. Exhibit A, Department Of Enforcement's Statement Of Undisputed Facts, Filed In Support Of Its Motion For Summary Disposition ("Enf. Statement Of Facts"), with Exhibits CX-1 through CX-5 ("CX-1" etc.);
   c. Department Of Enforcement's Opposition To Schwab's Motion For Summary Disposition ("Enf. Opp. To Schwab");
   d. Department Of Enforcement's Reply To Schwab's Opposition To Enforcement's Motion For Summary Disposition ("Enf. Reply Supporting Its Motion");

(3) Schwab's submissions:
   a. Charles Schwab & Co., Inc.'s Motion For Summary Disposition ("Schwab Motion");
   b. Statement Of Undisputed Facts In Support Of Schwab's Motion For Summary Disposition ("Schwab Statement Of Facts");
   c. Declaration of Gilbert R. Serota In Support Of Charles Schwab & Co., Inc.'s Motion For Summary Disposition ("Serota Decl.") with Exhibits A through W ("Ex. A" etc.);
   d. Charles Schwab & Co., Inc.'s Opposition To Department Of Enforcement's Motion For Summary Disposition ("Schwab Opp. To Enf.");
   e. Charles Schwab & Co., Inc.'s Reply In Support Of Its Motion For Summary Disposition ("Schwab Reply Supporting Its Motion").

October 2012 regarding the appropriate sanctions for the violation found in connection with Cause Three.[4]

This is the Hearing Panel's decision, explaining its conclusions and reasoning with respect to the violations alleged and the sanctions.[5]

II. OVERVIEW OF THE CASE AND THE HEARING PANEL'S DECISION

Causes One and Two concern the elimination of judicial class actions as an alternative to arbitration, while Cause Three concerns the attempt to deprive arbitrators of the power to consolidate individual claims. Enforcement maintains that the analysis begins and ends with whether the Waiver violates FINRA Rules. Schwab maintains that the Federal Arbitration Act ("FAA") preempts enforcement of the FINRA Rules in issue, regardless of whether the Waiver violates FINRA Rules.

The Hearing Panel concludes that the Waiver violates FINRA Rules. However, the Hearing Panel further concludes (i) that the FAA bars FINRA from preserving judicial class

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[4] The following abbreviations refer to the filings on sanctions:

(i) Department Of Enforcement's Brief Regarding Sanctions For The Third Cause Of Action ("Enf. Sanctions Br.");
(ii) Respondent's Brief Regarding The Appropriate Remedy For The Panel's Finding On The Third Cause Of Action ("Resp. Sanctions Br."), accompanied by Declaration of Lowell Haky In Support Of Respondent's Brief Re The Appropriate Remedy For The Panel's Finding On The Third Cause Of Action ("Haky Decl."); and
(iii) Department Of Enforcement's Reply Brief Regarding Sanctions For The Third Cause Of Action ("Enf. Sanctions Reply").

[5] In the interim between the briefing on sanctions and the issuance of this decision, Schwab filed a supplemental declaration indicating that it had removed from its account agreements the phrase that is in issue in Cause Three. Schwab further explained in the supplemental declaration that it has begun the process of revising and replacing the relevant language in some 100 different hard-copy account application forms. Schwab believes that process will be completed by the end of the first quarter of 2013. Supplemental Declaration of Lowell Haky Re: Third Cause Of Action, filed on January 11, 2013 (which supplements the Haky Declaration filed by Schwab along with its brief on sanctions).

This decision, however, concerns the charges filed in the Complaint and the language of Schwab's Waiver at that time. For purposes of determining whether the language violated FINRA Rules, the decision discusses the consolidation language without regard for Schwab's subsequent actions to remove that language from its account agreements and application forms.

actions as an option despite a customer's pre-dispute agreement to arbitrate claims, but (ii) that the FAA does not bar FINRA from granting, circumscribing, or modifying the powers of FINRA arbitrators.

A. The Causes Of Action And The Parties' Contentions As To Rule Violations

(1) *Cause One: Alleged Conflict With Rules Prohibiting Any "Limit" On The Ability To File A "Claim" In Court That The Arbitration Forum Permits To Be Filed In Court, Because FINRA Arbitration Rule 12204(d) Preserves The Option To File A Customer Claim As Part Of A Judicial Class Action*

According to the Complaint, the new customer agreement language waiving the ability to bring or participate in judicial class actions is prohibited by NASD Rule 3110(f)(4)(C), which applied when Schwab introduced its Waiver, and FINRA Rule 2268(d)(3), which applies now.[6] These Rules prohibit a member from imposing "limits" on the ability of a party to file a "claim" in court if the rules of the forum where the claim might otherwise be filed "permit" filing in court. FINRA Rule 12204(d) of the Code of Arbitration Procedure for Customer Disputes ("Arbitration Rule 12204(d)")[7] provides that an individual claim may not go forward in arbitration while that claim is simultaneously included in a judicial class action.

Enforcement argues that Arbitration Rule 12204(d) "permits" the filing of "class action claims" in court and therefore concludes that the complete waiver of any ability to file class action claims in court constitutes a prohibited "limit" on a "claim" within the meaning of FINRA 2268(d)(3). Schwab's main argument against finding any conflict with subsection (d)(3) is that a class action is a type of procedure and not a "claim." Therefore, Schwab reasons, the reference

[6] NASD Rule 3110 applied prior to December 5, 2011, and FINRA Rule 2268 applied from that date forward. The provisions of these two Rules allegedly violated are identical. Reference here to one of these Rules includes reference to the other. Generally, the current FINRA Rule is cited.

[7] FINRA Arbitration Rule 12204(d) was in effect throughout the period in issue.

to permitted "claims" has nothing to do with class action procedure, and the elimination of that procedure does not "limit" FINRA's Rule.

(2) ***Cause Two: Alleged Conflict With Rules Prohibiting Any "Condition" That "Limits" Or "Contradicts" A FINRA Rule, Because FINRA Arbitration Rule 12204(d) Preserves The Option To File A Customer Claim As Part Of A Judicial Class Action***

The Complaint separately alleges that the waiver of the ability to bring or participate in judicial class actions violates NASD Rule 3110(f)(4)(A) and FINRA Rule 2268(d)(1), which prohibit "any condition" in a pre-dispute arbitration agreement that "limits or contradicts" FINRA Rules. Enforcement reiterates its view that Arbitration Rule 12204(d) permits the filing of class actions in court, and argues that the Waiver, by doing away with judicial class actions, constitutes an impermissible "limit" on or "contradiction" of Arbitration Rule 12204(d). Schwab argues that this Rule does not authorize class actions but rather provides only that *if* a claim is included in a judicial class action the claimant may not simultaneously pursue the claim in an arbitration proceeding. Accordingly, Schwab argues that its Waiver does not "limit" or "contradict" the Rule.

(3) ***Cause Three: Alleged Conflict With Rules Prohibiting Any "Condition" That "Limits" Or "Contradicts" A FINRA Rule, Because FINRA Arbitration Rule 12312 Authorizes Consolidation Of Individual Claims In Arbitration***

The Complaint also challenges other new language in the Schwab customer agreement that purports to limit the authority of the arbitrators in any dispute between Schwab and its customers. Pursuant to the new language, Schwab and the customer agree that "the arbitrator(s) shall have no authority to consolidate more than one parties' [sic] claims."

FINRA Arbitration Rule 12312,[8] however, provides that one or more parties in an arbitration proceeding may submit multiple claims jointly. The Rule grants the Director of

[8] FINRA Arbitration Rule 12312 was in effect throughout the period in issue.

Arbitration the power, prior to the appointment of a panel of arbitrators, both to separate claims submitted jointly and to initiate consolidation of individual claims. After the appointment of a panel of arbitrators, the Rule authorizes the panel of arbitrators to override any decision of the Director regarding consolidation. Thus, arbitrators have final authority to decide whether to arbitrate on a consolidated basis. Since Rule 12312 authorizes consolidation but FINRA Arbitration Rule 12204(a) expressly prohibits arbitration on a class action basis, it is clear that consolidation is a non-representative type of procedure, distinguished from class actions.

Enforcement contends that Schwab's imposition of an agreement to limit the power of arbitrators in FINRA proceedings to consolidate multiple individual claims is an impermissible "limit" on or "contradiction" of Arbitration Rule 12312 in violation of NASD Rule 3110(f)(4)(A) and FINRA Rule 2268(d)(1). Schwab contends that its Waiver does not affect the ability of customers to submit claims jointly or the power of the Director. Schwab explains that it intended the language in issue to prevent arbitrators from rendering the Waiver ineffective by using consolidation to create class actions.

B. The Parties' Contentions Regarding The Federal Arbitration Act

Enforcement argues that if Schwab's Waiver contradicts and violates FINRA's Rules then the analysis ends there – sanctions must be imposed. According to Enforcement, the FAA is irrelevant. To the contrary, Schwab argues, even if the Waiver contradicts and violates FINRA's Rules, the FAA applies and forecloses enforcement of the Rules. According to Schwab, the FAA requires that Schwab's arbitration agreement, including the new Waiver, be given effect.

C. The Hearing Panel's Conclusions

As discussed more fully below, the Hearing Panel concludes that the specified provisions of Schwab's Waiver contradict and violate FINRA's Rules. The elimination of judicial class actions conflicts with FINRA Rules that are designed to preserve the option of pursuing customer claims in judicial class actions in preference to arbitration. The language depriving arbitrators of the power to consolidate claims in arbitration conflicts with the fundamental operation of FINRA's Rules governing its arbitration forum and with specific Rule provisions relating to consolidation.

Supreme Court precedent, however, compels the Hearing Panel to conclude that the FAA bars enforcement of FINRA's Rules to the extent that the Rules require that customers be given the option to bring their claims in court in the form of judicial class actions, despite any pre-dispute agreement to resolve disputes in arbitration. Rules that override an agreement to arbitrate and allow a party to an arbitration agreement to avoid arbitration represent the kind of "hostility" to arbitration that the Supreme Court has repeatedly found inappropriate and unenforceable under the FAA. In *Shearson/American Express Inc. v. McMahon*[9] and *Rodriguez de Quijas v. Shearson/American Express, Inc.*,[10] the Supreme Court established that securities law claims are no exception to the FAA's mandate that a party to an arbitration agreement must go to arbitration to resolve any claim subject to the agreement. In *AT&T Mobility LLC v. Concepcion*[11] the Court established that class actions are no exception either, holding that a party to an arbitration agreement has no right to participate in a class action instead of arbitration on an individual basis.

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[9] *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220 (1987).

[10] *Rodriguez De Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989).

[11] *AT&T Mobility LLC v. Concepcion*, 563 U.S. ___, 131 S. Ct. 1740, 2011 U.S. LEXIS 3367 (2011).

The Hearing Panel reads these and other Supreme Court precedents to mean that countervailing policy concerns that might counsel against arbitration of a particular kind of dispute – whether state or federal, statutory or regulatory – cannot override the FAA's mandate, unless there is a clear expression of *congressional* intent to carve out an exception to the FAA. Without an indication that Congress itself wished to create an exception to the FAA, other policy makers must give way to the FAA. In the case at hand, the Hearing Panel finds no such clear expression of *congressional* intent to preserve judicial class actions as an option for customer claims against a securities broker-dealer in direct contradiction of an agreement to arbitrate those claims.

The FAA does *not*, however, preclude enforcement of FINRA's Rules governing the powers of FINRA arbitrators and the procedures for FINRA arbitration. The FAA is focused on requiring those who have agreed in advance to resolve their disputes by arbitration to go to arbitration after a dispute arises and enforcing any decision the arbitrators may reach, not on regulating the governance of arbitration forums or arbitration procedures. The consolidation language in Schwab's Waiver does not have to do with avoiding arbitration. Rather, the consolidation language concerns how FINRA's arbitration forum will be governed and operated and the manner in which arbitration will be conducted. Accordingly, the Hearing Panel concludes that the consolidation of claims provision in the Waiver improperly attempts to circumscribe the power of FINRA arbitrators.

The Hearing Panel grants Schwab's motion for summary disposition on the first two Causes of Action (concerning judicial class actions), and dismisses them. The Hearing Panel finds a violation as alleged in the third Cause (concerning consolidation), and grants Enforcement's motion for summary disposition as to that Cause. The Panel imposes sanctions

with respect to the third Cause only.[12] The basis for the Panel's decision is set forth more fully below.

III. SUMMARY DISPOSITION STANDARD

Pursuant to FINRA Procedural Rule 9264(a), any party may file a motion for summary disposition prior to the hearing on the merits. Such a motion may seek disposition of any or all causes of action. If the decision on a motion for summary disposition does not fully adjudicate the matter, a hearing may still be necessary. If that is the case, the hearing panel is authorized to take various steps pursuant to FINRA Procedural Rule 9264(c) to narrow the issues in dispute and direct further proceedings "as are just." FINRA 9264(e) sets forth the standard for deciding any motion for summary disposition:

> The Hearing Panel ... may grant the motion for summary disposition if there is no genuine issue with regard to any material fact and the Party that files the motion is entitled to summary disposition as a matter of law.[13]

[12] As noted in the synopsis, the Complaint alleges that Schwab violated FINRA Rule 2010 by virtue of the other Rule violations alleged in the Complaint. Compl. ¶¶ 20, 26, and 32. Because the alleged Rule 2010 violations turn on whether the underlying conduct violated other FINRA Rules, the FINRA Rule 2010 violations are not separately discussed in this decision, except to note here that the violation of other Rules found in connection with Cause Three is also a violation of FINRA Rule 2010. It is inconsistent with the duties imposed by Rule 2010 to violate other NASD and FINRA Rules, as the Securities and Exchange Commission has consistently held. *See Alvin W. Gebhart*, Exchange Act Rel. No. 53136, 2006 SEC LEXIS 93, at *54 n.75 (Jan. 18, 2006), *rev'd and remanded in part on other grounds sub. nom Gebhart v. SEC*, 2007 U.S. App. LEXIS 27183 (9th Cir. Nov. 21, 2007). *See also Richard F. Kresge*, Exchange Act Rel. No. 55988, 2007 SEC LEXIS 1407, at *42 (June 29, 2007).

[13] FINRA Procedural Rule 9264(e) also provides that: "the facts alleged in the pleadings of the Party against whom the motion is made shall be taken as true, except as modified by stipulations or admissions made by the non-moving Party, by uncontested affidavits or declarations, or by facts officially noticed pursuant to Rule 9145." The facts set forth in the Parties' joint stipulation are deemed true. The Parties also have submitted exhibits such as Schwab customer agreements and amendments to those agreements, as well as publicly available history of the promulgation of FINRA's Rules and other materials. The existence, authenticity, and content of those materials are not disputed.

The summary disposition standard is based on the standard for summary judgment motions in civil litigation, and federal judicial decisions on summary judgment motions provide guidance.[14] The courts have long held that summary judgment should be granted where there is no genuine dispute as to any material fact and the moving party is entitled to judgment as a matter of law.[15]

IV. JURISDICTION

There is no dispute that FINRA has jurisdiction over Schwab in this disciplinary proceeding alleging violations of FINRA Rules. Schwab has been a FINRA member firm since 1970.[16] In its application for membership and subsequent amendments to that application, Schwab agreed to abide by and adhere to FINRA's Rules.[17] FINRA Rule 0140 expressly states: "The Rules shall apply to all members and persons associated with a member," and courts have recognized that FINRA membership constitutes an agreement to adhere to FINRA's Rules.[18]

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[14] *See, e.g., Dep't of Enforcement v. Claggett*, No. 20050006315101, 2007 FINRA Discip. LEXIS 2, at *8 n.2 (NAC Sept. 28, 2007) (stating that Federal Civil Procedural Rule 56 is guidance on a summary disposition motion); *Dep't of Enforcement v. U.S. Rica Fin., Inc.*, No. C01000003, 2003 NASD Discip. LEXIS 24, at *12 (NAC Sept. 9, 2003) (stating that federal law provides significant guidance in cases involving motions for summary disposition); Order Approving a Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Amendments to the Code of Procedure and Other Provisions, Exchange Act Rel. No. 43102, 2000 SEC LEXIS 1584, at *7 (Aug. 1, 2000) (approving proposal "to modify NASD Rule 9264(a) to track the language in the [Federal Rules of Civil Procedure] . . . ."). *See also Dep't of Enforcement v. Harvest Capital Investments LLC*, 2007 FINRA Discip. LEXIS 6 (OHO Sept. 27, 2007).

[15] *See, e.g., Celotex v. Catrett*, 477 U.S. 317 (1986); *Shuler v. Bd. of Trustees. Of Univ. of Ala.*, 2012 U.S. App. LEXIS 13525, at *7-8 (11th Cir. July 3, 2012); *Regions Bank v. Law Offices of Sherin Thawer, P.C.*, 2012 U.S. Dist. LEXIS 50120, at *7-9 (N.D. Tex. Apr. 10, 2012).

[16] Jt. Stip. ¶ 1; Complaint ¶ 10; Answer ¶ 10. The Securities Exchange Act of 1934 ("Exchange Act") requires broker-dealers to become members of a self-regulatory organization ("SRO") (such as FINRA), to abide by the rules of the SRO, and to be subject to the SRO's disciplinary process. *See* Sections 15(b), 15A(b), and 19(e) of the Exchange Act, 15 U.S.C. § 78o(b), § 78o(A)(b), and § 78s(b).

[17] Complaint ¶ 11; Answer ¶ 11.

[18] *See, e.g., In re American Express Financial Advisors Sec. Litig.*, 672 F.3d 113, 128 (2d Cir. 2011).

V. THE FINRA AND NASD RULES IN ISSUE

A. The Prohibition On "Limits:" FINRA Rule 2268(d) And NASD Rule 3110(f)(4)

FINRA Rules 2268(d)(1) and (d)(3), and their predecessors, NASD Rules 3110(f)(4)(A) and (4)(C), are identical in relevant part. FINRA Rules 2268(d)(1) and (d)(3) provide:

> No predispute arbitration agreement shall include any condition that:
>
> (1) limits or contradicts the rules of any self-regulatory organization;
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> ....
>
> (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 prohibition on "limit[ing]" (and, in the case of subsection (d)(1), also on "contradict[ing]") SRO Rules ensures that investor disputes with broker-dealers are handled in a consistent fashion, according to rules that have been reviewed and approved by the Securities and Exchange Commission ("SEC") as contributing to investor protection and the public interest, and subject to efficient and effective oversight by SROs such as FINRA.

In 1989, the arbitration rules of NASD and other SROs were amended to prohibit "any language" in a pre-dispute arbitration agreement that "limits or contradicts the arbitration rules of any self-regulatory organization."[19] The SEC explained in the approving release for the 1989 amendments that the Rules are designed to "strengthen investor confidence in the arbitration systems at the SROs, both by improving the procedures for administering the arbitrations and by

[19] *See* Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc., National Association of Securities Dealers, Inc., and the American Stock Exchange, Inc. Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, Exchange Act Rel. No. 26805, 1989 SEC LEXIS 843 (May 10, 1989) (1989 Approving Release). NASD members were informed in an August 1989 Notice To Members that the amendments included an express prohibition on the use of language that would "limit" or contradict" an SRO's arbitration rules. NTM 89-58, 1989 NASD LEXIS 107, at *2-3 (Aug. 1989).

creating clear obligations regarding the use by SRO members of predispute arbitration clauses."[20] The SEC repeated that SRO arbitration should provide for "equitable and efficient administration of justice."[21] With respect to the provision that ultimately became FINRA Rule 2268(d)(1), the SEC expressly stated that it "believe[d] that the new provision in the rule prohibiting firms from including in their agreements any condition which limits or contradicts the rule of any SRO ... benefits investors."[22]

B. Class Actions: FINRA Arbitration Rule 12204

FINRA Arbitration Rule 12204(a) provides that "[c]lass action claims may not be arbitrated under the Code."[23] However, other portions of Rule 12204 contemplate that claims can be brought as class actions in court. Rule 12204(b) provides that "[a]ny claim that is based

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[20] 1989 Approving Release, 1989 SEC LEXIS 843, at *63-64. As the NASD explained in a Notice To Members, the amendment prohibited "the use in any agreement of any language that limits or contradicts the arbitration rules of any self-regulatory organization, limits the ability of a party to file a claim in arbitration, or limits the ability of the arbitrators to make an award under the arbitration rules of a self-regulatory organization and applicable law." NTM 89-58, 1989 NASD LEXIS 107, at *1. The NASD and other SROs, along with the SEC, sought to address "issues regarding the fairness and efficiency of the arbitration process administered by the SROs." 1989 Approving Release, 1989 SEC LEXIS 843, at *1.

[21] 1989 Approving Release, 1989 SEC LEXIS 843, at *64.

[22] *Id.* at *61. The SEC also noted that the provision was "a clear statement of existing law," citing to NASD, NYSE, and AMEX arbitration rules. *Id.* at n.57.

[23] FINRA's general approach to claims brought on a representative basis on behalf of a group has been consistent. FINRA declines to arbitrate representative claims brought on behalf of groups. For example, Arbitration Rule 12205 for customer-industry disputes provides that "[s]hareholder derivative actions may not be arbitrated under the Code." Arbitration Rule 13205 for intra-industry disputes contains a parallel provision regarding shareholder derivative actions.

Similarly, for intra-industry disputes, FINRA has refused to arbitrate so-called "collective actions" that may be brought by employees against employers under the Fair Labor Standards Act, the Age Discrimination Act, and the Equal Pay Act of 1963, treating them as a form of class action. NTM 12-28, 2012 FINRA LEXIS 35 (June 2012). Some federal courts, however, compelled arbitration of collective actions, holding that collective actions are distinct from class actions and not covered by FINRA's Rules regarding class actions. In response, FINRA proposed amendments to its Arbitration Rules for intra-industry disputes that would prohibit arbitration of collective actions. The SEC approved those amendments and they became effective July 9, 2012. *Id.* at *2. Like the class action provisions for customer claims, the new provisions regarding collective actions provide that a claim that is part of a collective action being pursued in court may be arbitrated on an individual basis only if the individual provides evidence that he or she is not participating in the group action. *Id.* at *5.

upon the same facts and law, and involves the same defendants" as a court-certified or putative class action either in court or in another arbitration forum will not be arbitrated under the Customer Arbitration Code unless the claimant provides evidence that he or she will not participate in any class action recovery. Rule 12204(c) then sets forth procedures for determining any dispute over whether a claim is covered by class action.

Finally, Rule 12204(d) prohibits enforcement of an arbitration agreement as to any "claim" that is the subject of a certified or putative "class action" until one of four events occurs that takes the claim out of the class action. Arbitration of the claim can only be compelled after class certification is denied, the class is decertified, a court excludes the class member from the class, or the class member withdraws from the class. This is the provision that Enforcement cites as the basis for its argument that FINRA Rules "permit" claims to be filed as judicial class actions.[24]

The SROs first expressly addressed class actions in the early 1990s, based on rule changes developed by the Securities Industry Conference on Arbitration for the Uniform Code of Arbitration. In 1992, NASD introduced the provisions now found in FINRA Arbitration Rules 12204(a) and 12204(d), providing that class actions may not be arbitrated and that members may not move to compel arbitration of any claim included in a judicial class action unless and until the claim is removed from the class action.[25] In response to comments on the proposed amendments, NASD declared, "[T]he bar on class actions in arbitration was designed to provide investors with access to the courts, which already have developed the procedures and the

[24] Arbitration Rule 13204 for intra-industry disputes contains identical provisions concerning class actions.

[25] SEC approving release for amendments to NASD Code of Arbitration Procedure and Rules of Fair Practice, Exchange Act Rel. No. 31371, 1992 SEC LEXIS 2767, 57 Fed. Reg. 42659 (Oct. 28, 1992).

expertise for managing class actions."[26] The SEC said in its adopting release, "The Commission agrees with the NASD's position that, in all cases, class actions are better handled by the courts and that investors should have access to the courts to resolve class actions efficiently."[27] It reiterated, "The Commission believes that investor access to the courts should be preserved for class actions...."[28]

C. Consolidated Claims: FINRA Arbitration Rule 12312

FINRA Arbitration Rule 12312 grants and circumscribes the powers of the Director of Arbitration and FINRA arbitrators to join multiple claims. These are not representative claims brought on behalf of a group, but, rather, similar individual claims brought by individual claimants. In contrast to FINRA's consistent practice of not arbitrating claims brought on a representative basis (such as class actions, derivative actions, and collective actions), FINRA expressly provides for the arbitration of individual claims on a consolidated basis. Rule 12312 provides, in full:

> (a) One or more parties may join multiple claims together in the same arbitration if the claims contain common questions of law or fact and:
>
> • The claims assert any right to relief jointly and severally; or
>
> • The claims arise out of the same transaction or occurrence, or series of transactions or occurrences.
>
> (b) After all responsive pleadings have been served, claims joined together under paragraph (a) of this rule may be separated into two or more arbitrations by the Director before a panel is appointed, or by the panel after the panel is appointed. A party whose claims

[26] *Id.* at *5-6.

[27] *Id.* at *8-9.

[28] *Id.* at *9.

> were separated by the Director may make a motion to the panel in the lowest numbered case to reconsider the Director's decision.[29]

NASD arbitrators were first expressly granted final decision-making authority with respect to consolidation in 1984.[30] NYSE expressly granted its arbitrators final authority over consolidation in 1990, codifying prior practice.[31] During the same period, other SROs adopted similar amendments that expressly authorized arbitrators to determine issues relating to permissive joinder and consolidation.[32]

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[29] Two other Arbitration Rules empower the Director of Arbitration and arbitrators to deal with multiple parties and claims in customer-industry disputes. FINRA Arbitration Rule 12313 provides that multiple respondents may be named in the same arbitration if questions of law or fact are common to all the respondents and the claims assert a right to relief against the respondents jointly and severally or arise out of the same transaction or occurrence or series of events. Under Rule 12313, the Director and the panel have the same powers as to multiple respondents as they do under Rule 12312 as to multiple claimants. Prior to appointment of a panel, the Director may separate claims joined together under Rule 12313, but after a panel is appointed it may reconsider any decision by the Director to separate the claims. FINRA Arbitration Rule 12314 separately empowers the Director of Arbitration to "combine separate but related claims into one arbitration" prior to receiving panel rankings. It also provides that "[o]nce a panel has been appointed, the panel may reconsider the Director's decision upon motion of a party."

[30] In 1984, after SEC approval, FINRA's predecessor, NASD, promulgated amendments to its Uniform Code of Arbitration (which included the procedures for all arbitrations, whether between customers and industry members or solely among members of the industry). These amendments included language granting the Director of Arbitration the authority to make a preliminary determination whether multiple parties should proceed in the same or separate arbitrations but expressly empowering the arbitrators to make "[a]ll final determinations with respect to joining, consolidation and multiple parties." NTM 84-51, 1984 NASD LEXIS 330, at *9 (Sept. 28, 1984).

[31] In 1990, the SEC approved a proposed amendment of NYSE Rule 612 concerning the initiation of arbitration proceedings. The SEC declared that the amendment concerning consolidation "should avoid confusion" regarding when consolidation or joinder was appropriate because the amendment set forth the standard for making that judgment. Exchange Act Rel. No. 28421, 1990 SEC LEXIS 3095, at *2-4 (Sept. 10, 1990). *See also* NYSE Info. Memo 90-46, 1990 NYSE Info. Memo LEXIS 24, at *2 (Oct. 2, 1990) ("The amendment to Rule 612 codifies the Exchange's practice of permitting parties to join in an arbitration if there exist common questions of law or fact.").

[32] *See, e.g.*, the SEC's approving release for amendments to the arbitration code of the American Stock Exchange, Inc., Exchange Act Rel. No. 29087, 1991 SEC LEXIS 710, at *2-3 (Apr. 15, 1991).

VI. THE FEDERAL ARBITRATION ACT

The FAA was enacted in 1925 to prevent parties to arbitration agreements from evading their commitment to arbitrate disputes and ensure the enforcement of valid arbitration agreements.[33] Three provisions of the FAA are particularly critical to the enforcement of arbitration agreements. Section 2 provides that any "written provision" in a "contract evidencing a transaction in commerce" whereby the parties agree "to settle by arbitration a controversy thereafter arising out of such contract or transaction" shall be "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."[34] Section 3 provides that where an issue "referable to arbitration" is nevertheless submitted to a federal court, the court shall stay trial of the action upon application of a party until arbitration is completed in accord with the agreement to arbitrate.[35] Section 4 provides that where a party to an arbitration agreement refuses to go to arbitration to resolve a dispute the other party to the agreement may petition a federal district court for an order to compel arbitration. If the court is satisfied that the dispute is subject to an agreement to arbitrate, the court is authorized to issue an order directing the parties to proceed with arbitration.[36]

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[33] An Act: To make valid and enforceable written provisions or agreements for arbitration of disputes arising out of contracts, maritime transactions, or commerce among the States or Territories or with foreign nations, commonly known as the Federal Arbitration Act, Pub. L. 68-401, 43 Stat. 883 (1925) (codified at 9 U.S.C. § 1 *et seq.*).

[34] 9 U.S.C. § 2.

[35] 9 U.S.C. § 3.

[36] 9 U.S.C. § 4.

VII. FACTS

A. Schwab's New Pre-Dispute Arbitration Language Bars Judicial Class Actions And Deprives FINRA Arbitrators Of Any Power To Consolidate Individual Claims

The material facts are not in dispute. During the first week of October 2011, Schwab sent over 6.8 million existing account holders their September 2011 monthly account statements, accompanied by amendments to the customers' account agreements with Schwab. The amendments included the Waiver. Under the terms of the account agreements, the amendments were effective upon notification to Schwab's customers.[37] Schwab also included the Waiver in account agreements for new accounts opened with it from October 1, 2011, onward. Tens of thousands of customers agreed to the Waiver in opening accounts with Schwab.[38] Schwab used the same version of the Waiver in all these account agreements.[39]

The Waiver provides as follows:

> 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 consolidate more than one parties' [sic] claims or 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.[40]

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[37] Jt. Stip. ¶¶ 2-3.

[38] Jt. Stip. ¶ 5.

[39] Jt. Stip. ¶¶ 4, 6.

[40] Complaint ¶ 13; Answer ¶ 13; Jt. Stip. ¶ 4; Enf. Statement of Facts, CX-2, at. 2-3.

B. Schwab's Agreements Incorporate FINRA Arbitration Rules And Also Specify That The Federal Arbitration Act Applies

Schwab produced 13 pre- and post-amendment customer agreements for various types of accounts to provide a context for the introduction of the Waiver.[41] Both before and after the Waiver, Schwab's customer agreements provide the same explanation of the effect of signing the Arbitration Agreement. All claims will be resolved by arbitration:

> All parties to this Agreement are giving up the right to sue each other in court, including the right to a trial by jury, except as provided by the rules of the arbitration forum in which a claim is filed.[42]

[41] Documents produced by Schwab pursuant to Office of Hearing Officer's May 14, 2012 Order for Production ("Schwab Binder of Agreements"). The October 2011 amendments with the new language of the Waiver were sent to customers as part of a 40-page document entitled "Important account information you need to know." Schwab Binder of Agreements, Item 1. Amendments appear on pages 27 through 40 and include other matters in addition to the arbitration amendments. *Id.* at 27-40. The Waiver in issue is one of five amendments to the arbitration provisions of Schwab's customer agreements. *Id.* at 29-30. All five arbitration amendments take up less than two pages of the 40-page document sent to customers. *Id.* An introductory letter to the investor explains that the amendments will become effective immediately and "replace and supersede" previous portions of the customer agreement to which the amendments applied. *Id.* at 28. That letter specifies that in the event of any inconsistency or conflict between the new and old agreements, the terms of the new agreement would apply. *Id.* The Waiver appears in the post-amendment January 2012 customer agreement and other post-amendment customer agreements at the end of the Arbitration Agreement. Schwab Binder of Agreements, Item 3, at 22-23. *See also* Schwab Binder of Agreements, Item 5, at 54; Item 7, at 24; Item 9, at 22; and Item 13, at 20.

[42] *E.g.*, Schwab Binder of Agreements, Item 2, at 19; Item 3, at 19. Other post-amendment customer account agreements similarly specify that "[a]ny controversy or claim" will be "settled by arbitration," and that "[s]uch arbitration will be conducted by, and according to the securities arbitration rules then in effect of [FINRA]" (or in appropriate circumstances one of the alternative arbitration forums). *See, e.g.*, Schwab Binder of Agreements, Item 11, at 18-21.

Schwab's Arbitration Agreements make clear that FINRA's Arbitration Rules will apply to any claim submitted to FINRA arbitration:

> The rules of the arbitration forum in which the claim is filed, and any amendments thereto, shall be incorporated into this Agreement.[43]

Schwab's customer agreements also expressly state that the FAA is the governing law with regard to Schwab's arbitration agreements.[44]

C. Schwab Introduced The Waiver As A Result Of The U.S. Supreme Court's Decision In *Concepcion*, Upholding A Class Action Waiver

Schwab's introduction of the Waiver in fall of 2011 was no accident. It occurred shortly after the U.S. Supreme Court's decision in *AT&T Mobility LLC v. Concepcion*,[45] in which the Court overturned a decision of the Ninth Circuit Court of Appeals that had held an arbitration agreement unconscionable and unenforceable under what was known as the *Discover Bank* doctrine, after a 2005 decision by the California Supreme Court.

In the *Discover Bank* case, the California Supreme Court had held that a class action waiver in a consumer contract of "adhesion" was unenforceable where the small amounts of

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[43] *E.g.*, Schwab Binder of Agreements, Item 2, at 19. The Arbitration Agreements further reiterate that disputes will be resolved by arbitration and that the rules of the arbitration forum will apply, by specifying that any "controversy or claim arising out of or relating to" the customer agreement or any other agreement or relationship with Schwab or related third parties, including service providers, "will be settled by arbitration," and that the "arbitration will be conducted by, and according to the securities arbitration rules and regulations then in effect" of FINRA, or, if Schwab is a member, the arbitration rules of any national securities exchange that provides an arbitration forum. *Id.* at 19-20. If arbitration before FINRA or an eligible national securities exchange is for any reason "unavailable or impossible," then arbitration will take place under the rules of the American Arbitration Association ("AAA"). Failing AAA arbitration, the Arbitration Agreement provides for a court to appoint arbitrators. *Id.* at 20. *See also* Schwab Binder of Agreements, Item 3, at 20-23.

[44] *E.g.*, Schwab Binder of Agreements, Item 3, at 18 ("Governing Law").

[45] *Concepcion*, 563 U.S. ___, 131 S. Ct. 1740, 2011 U.S. LEXIS 3367 (2011).

money involved in individual claims meant, in practical terms, that the party with superior bargaining power could insulate itself from customer claims.[46] Under the *Discover Bank* doctrine, class actions were required to be available for cases where the small amount of an individual claim created too little incentive for the individual claimant to assert his or her rights in court. California courts frequently applied the *Discover Bank* doctrine to find consumer arbitration agreements containing class action waivers unconscionable and unenforceable.[47]

In essence, the California courts created a public policy exception to the mandate in the FAA that disputes covered by an agreement to arbitrate must be resolved by arbitration in accord with the agreement. The California courts declined to enforce arbitration agreements that eliminated class actions because they viewed it better public policy to preserve class actions for some types of claims.

In *Concepcion*, the Supreme Court viewed the *Discover Bank* doctrine as insisting on the availability of class-wide procedures despite the existence of an arbitration agreement providing otherwise.[48] The Court rejected that insistence and instead enforced the agreement to arbitrate. The Court held in *Concepcion* that Section 2 of the FAA preempts the *Discover Bank* doctrine and requires the enforcement of arbitration agreements according to their terms – even where that means that class-wide procedures will be unavailable. The Court described Section 2 of the FAA as "reflecting both a 'liberal federal policy favoring arbitration' ... and the 'fundamental principle that arbitration is a matter of contract.'"[49]

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[46] *Discover Bank v. Superior Court*, 30 Cal. Rptr. 3d 76 (2005).

[47] *Concepcion*, 2011 U.S. LEXIS 3367, at ***12-13.

[48] *Id.* at ***23-24.

[49] *Id.* (citations omitted).

Schwab, with its headquarters based in California, typically includes a California choice-of-law provision in its customer agreements.[50] Accordingly, California arbitration law was, and is, of significant concern to Schwab.[51] The Supreme Court's decision in *Concepcion* rejecting the California courts' public policy exception to the FAA caused Schwab to re-examine its pre-dispute arbitration agreement for customer accounts, and ultimately led Schwab to amend its customer agreements in fall 2011 to include the Waiver.[52]

With this background, the Hearing Panel now addresses whether the Waiver violates FINRA Rules, and, if so, whether the FAA bars enforcement of those Rules.

VIII. SCHWAB'S WAIVER VIOLATES FINRA RULES

A. Schwab's Waiver Bars Judicial Class Actions That Arbitration Rule 12204 Is Designed To Preserve, In Violation Of FINRA Rule 2268(d)(1) and (d)(3) and NASD Rule 3110(f)(4)(A) and (4)(C) – Causes One And Two

The first two Causes of Action raise essentially the same issue: whether, by eliminating any ability to bring or participate in judicial class actions, Schwab's Waiver deprives a customer of the ability to do something that FINRA's Rules permit the customer to do.[53] The Hearing Panel concludes that the Waiver does deprive the customer of the ability to bring or participate in

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[50] *See* Schwab Motion at 4 and n.6. *See also* the "Governing Law" provisions of the Schwab customer agreements, Schwab Binder of Agreements, Item 2, at 18, 67; Item 3, at 18; Item 4, at 50; Item 5, at 50-51; Item 6, at 20; Item 7, at 20; Item 8, at 18; Item 9, at 18; Item 10, at 16; Item 11, at 17; Item 12, at 16; and Item 13, at 16.

[51] Oral Arg. Tr. at 7-8. Arguably, because Schwab unilaterally imposes arbitration agreements and amendments on its customers, as described above in the context for the Waiver in issue, Schwab's agreements might be considered consumer contracts of "adhesion" that would be covered by the *Discover Bank* doctrine.

[52] Schwab Opp. To Enf. at 20-21 (arguing that Schwab created the Waiver based on a good faith interpretation of the Supreme Court's decision in *Concepcion*); Oral Arg. Tr. at 7-9; Enf. Statement of Facts, CX-3, at 1-4 (background and argument by Schwab's outside counsel regarding Schwab Waiver). *See also Charles Schwab & Co. v. Financial Industry Regulatory Authority Inc.*, 2012 U.S. Dist. LEXIS 72788, at *9-10 (N.D. Cal. May 11, 2012).

[53] Rule 2268(d)(1) prohibits a pre-dispute arbitration agreement that "limits" or "contradicts" any SRO (including any FINRA) Rule. Rule 2268(d)(3) prohibits a pre-dispute arbitration agreement that "limits" a customer's ability to file a "claim" in court that FINRA Rules "permit" to be brought in court. Both Causes allege a "limit" or "contradiction" of FINRA Rule 12204(d), which provides that a customer cannot be compelled to arbitrate a claim while that claim is part of a judicial class action.

a judicial class action, as permitted by FINRA Rule 12204, in a violation of both subsection (d)(1) and subsection (d)(3) of FINRA Rule 2268.

A common sense reading of FINRA Rule 12204 in conjunction with FINRA Rules 2268(d)(1) and (d)(3) supports the conclusion that Schwab's Waiver does "limit" and "contradict" FINRA Rule 12204 in violation of Rules 2268(d)(1) and (d)(3).[54] FINRA Rule 12204 contemplates that a customer claim may be adjudicated in a judicial class action or in an arbitration proceeding. It is clearly premised on the availability of judicial class actions, and allows customer claims to be pursued in that manner in a judicial forum, rather than by arbitration.

The history of Rule 12204 also indicates that it was intended and designed to preserve judicial class actions as an option. In 1992, when NASD proposed the provisions now found in Rule 12204 concerning class action claims, NASD said that those provisions were developed in response to suggestions by former SEC Chairman David S. Ruder that NASD "consider adopting procedures that would give investors access to the courts in appropriate cases, including class actions."[55] Later in 1992, when the SEC approved what is now Rule 12204, the SEC explained that it believed that investors should have access to courts for resolution of class actions.[56]

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[54] The Parties have argued Cause One and Cause Two separately because the subsections of 2268(d) contain different language. In connection with Cause One, which involves FINRA Rule 2268(d)(3), Enforcement argues that "class action claims" are a subcategory of "claims" that the Rule preserves for resolution in court. Schwab argues that a "class action" is a type of procedure, not a "claim," and that nothing in section (d)(3) bars a waiver of judicial class action procedures. Each Party has some textual support for its views, but neither position is wholly free of ambiguity.

The Hearing Panel rests its decision instead on the operation, design, and history of Rules 2268(d)(1) and (d)(3) and Arbitration Rule 12204. The Rules operate together and were clearly intended – and have been understood – to preserve customers' option to participate in a judicial class action despite any pre-dispute arbitration agreement.

[55] Notice of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Improvements in the NASD Code of Arbitration Procedure, Exchange Act Rel. No. 30882, 1992 LEXIS 1566, at *5-6 (July 1, 1992).

[56] SEC approving release for amendments to NASD Code of Arbitration Procedure and Rules of Fair Practice, Exchange Act Rel. No. 31371, 1992 SEC LEXIS 2767, 57 Fed. Reg. 42659 (Oct. 28, 1992).

The force of Rule 12204 is preserved by FINRA Rules 2268(d)(1) and (d)(3). Both are designed to prevent a FINRA member firm from putting into its customer arbitration agreements terms different from what FINRA's Rules provide. Subsection (d)(1) broadly encompasses any limitation or contradiction of any Rule. Subsection (d)(3) more narrowly specifies that a member firm may not limit the ability of a customer to file a claim in court that FINRA permits to be filed in court. These provisions operate in conjunction with Rule 12204 to preserve the option for customer claims to be resolved in court in a class action.

If construed otherwise, Rule 2268(d)(3) would have no purpose and would be meaningless. If Rule 2268(d)(3) and its prohibition of any agreement not to bring a "claim" in court that the arbitration forum "permits" to be filed in court, is not viewed to refer to "class action claims" protected by Rule 12204, it does not refer to anything. This is because there is nothing in the Customer Arbitration Code that preserves or "permits" a right to go to court to assert any other type of "claim." Rather, Rule 12200 mandates arbitration of any dispute between a customer and a FINRA member that has to do with the member's business, without exception.

For two decades, the industry has understood these Rules to operate together to preserve customers' ability to bring or participate in judicial class actions. NASD, FINRA's predecessor, made clear in a December 1992 Notice To Members concerning Rule 2268 that no customer could be compelled to arbitrate a claim while that claim was subject to a class action. NASD declared, "Accordingly, neither members nor their associated persons may use an existing arbitration agreement to compel a customer to arbitrate a claim included in a class action."[57] This language indicates that NASD believed that customers retained the right to pursue claims in

[57] NTM 92-65, 1992 NASD LEXIS 23 (Dec. 1992).

judicial class action proceedings and that the Rules protected that right by prohibiting members from compelling customers to arbitrate unless and until they were no longer involved in a class action. By this Notice To Members, NASD made plain its interpretation of these Rules, and promoted a common understanding among its members.

The absence of class action waivers in broker-dealer pre-dispute arbitration agreements with customers until now, despite decades of class-action securities litigation in the courts, further demonstrates that the industry has understood the Rules to prohibit class action waivers in customer agreements. Schwab did not venture to impose such a waiver on customers until the Supreme Court's decision in *Concepcion* led it to believe that it had a basis for challenging FINRA's ability to impose the prohibition embodied in FINRA's Rules.[58]

Because Schwab's Waiver would bar customers from bringing or participating in judicial class actions, the Hearing Panel finds that the Waiver violates FINRA Rule 2268(d)(3) and NASD Rule 3110(f)(4)(C), as alleged in Cause One, and violates FINRA Rule 2268(d)(1) and NASD Rule 3110(f)(4)(A), as alleged in Cause Two. However, the conclusion that Schwab's Waiver violated these Rules does not end the analysis. The question remains whether the Rules are enforceable under the FAA, which is discussed below.

[58] Interpretation of the intra-industry version of these Rules has not been as consistent. *Compare, e.g., Good v. Ameriprise*, 2007 U.S. Dist. LEXIS 9298 (D. Minn. 2007) (held in context of intra-industry dispute that predecessor to Rule 12204 preserved the ability to pursue a claim by judicial class action) *with Cohen v. UBS Fin. Services, Inc.*, 2012 U.S. Dist. LEXIS 174700 (S.D.N.Y. Dec. 4, 2012) (held in context of intra-industry dispute that FINRA Rule 13204, the parallel Rule to Rule 12204 in customer disputes, does not prohibit a waiver of judicial class actions as an alternative to arbitration). In *Cohen*, the District Court found that enforcement of an arbitration agreement waiving any right to proceed by class or collective action was not inconsistent with FINRA's Rules for intra-industry disputes. Regardless of whether that conclusion is correct, it does not apply to customer-industry disputes, where the industry has long understood that judicial class actions were not merely permitted but were intended to be preserved as a customer option.

B. Schwab's Waiver Deprives FINRA Arbitrators Of Authority That FINRA Arbitration Rule 12312 Grants Them, In Violation Of FINRA Rule 2268(d)(1) – Cause Three

Cause Three involves the provision of Schwab's Waiver that declares "the arbitrator(s) shall have no authority to consolidate more than one parties' [sic] claims." This provision expressly requires a customer to agree to limit the authority of the arbitrators in connection with any claim covered by the pre-dispute arbitration agreement. The provision has nothing to do with class actions. Nor does it disfavor arbitration as a means of dispute resolution. It only comes into play once a claim has been submitted to arbitration, and it has to do with the powers of the arbitrators and the procedures of the arbitration forum.

Enforcement alleges that this provision "limits or contradicts" Rule 12312 in violation of FINRA Rule 2268(d)(1). As more fully set forth above, Rule 12312 permits one or more parties to join multiple claims together in the same arbitration and, if the Director of Arbitration separates the claims prior to the appointment of a panel of arbitrators, the arbitrators are empowered to re-join the claims and proceed with multiple claims in arbitration. NASD arbitrators first were granted express authority to consolidate or join claims in 1984, and NYSE arbitrators gained such express authority in 1990. Although the precise language of the Rules has changed over time, it has been plain for decades that arbitrators have the power to make all final determinations with respect to joining and consolidating the claims of multiple parties.

Schwab argues that Enforcement has misread the Waiver, and that the Waiver does not "limit or contradict" the authority of the arbitrators under Rule 12312. Rather, Schwab contends, customers continue to be able to submit multiple claims for arbitration in one proceeding as

provided in Rule 12312, and the Waiver only limits the ability of the arbitrators to create a class action in arbitration.[59]

As discussed below, the Hearing Panel finds that this provision of the Waiver "limits" and "contradicts" FINRA Rule 12312 for two separate, independent reasons. Schwab's arguments to the contrary are unpersuasive. The Hearing Panel therefore finds that Schwab violated FINRA Rule 2268(d)(1).

(1) ***Schwab's Attempt To Limit The Powers Of The Arbitrators "Contradicts" The Fundamental Operation Of Arbitration Rule 12312 And FINRA's Authority To Specify And Modify The Powers Of Its Arbitrators***

By its terms, Schwab's Waiver imposes a limitation on the power of the arbitrators. It specifies that the arbitrators "shall have no authority." The Waiver purports to determine by private agreement the scope of the arbitrators' authority, regardless of what FINRA's arbitration Rules might provide, now or in the future. Indeed, Schwab does not contest that the Waiver circumscribes what arbitrators may do. Instead, Schwab argues that the limitation does not conflict with other provisions of Rule 12312 governing what customers and the Director of Arbitration can do, an argument dealt with separately below.

Regardless of the specific limitation imposed by the Waiver, the attempt to dictate the powers of the arbitrators is inconsistent with the fundamental operation of FINRA Arbitration Rule 12132 and, indeed, the most basic FINRA requirement that members must comply with FINRA's Rules as amended from time to time.[60] FINRA Arbitration Rule 12132 governs procedures for joining the claims of multiple parties, and grants and circumscribes the powers of the arbitrators relating to the joinder of claims. As made plain in FINRA Arbitration Rule

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[59] Schwab Motion at 29-30; Oral Arg. Tr. at 18-19, 31-34.

[60] *See* FINRA Conduct Rule 0140 and FINRA By-Laws, Art. IV, Sec. 1.

12200, members must arbitrate "under the Code." This means that every member, including Schwab, is bound to arbitrate under the same Rules, as modified by FINRA from time to time pursuant to SEC oversight of the rulemaking process. Schwab cannot carve out for itself a different set of procedures from those specified by FINRA.

Public policy concerns for the protection of investors and efficiency concerns of the forum are both served by this conclusion. Otherwise each member firm could impose its own arbitration rules on customers, undercutting FINRA's ability to ensure that customer-member disputes are resolved in a fair and consistent manner and destroying FINRA's ability to manage its own forum efficiently. The SEC oversight of SRO arbitration forums that formed the basis of the Supreme Court's decisions in *Shearson* and *Rodriguez* (as discussed below) would also be severely undermined.

(2) ***Schwab's Prohibition Against "Consolidation" Also Specifically "Limits" And "Contradicts" Arbitration Rule 12312, Which Authorizes Arbitrators To Make The Final Decision On Joinder Of Multiple Claims In Arbitration***

By its express language, Arbitration Rule 12312 authorizes arbitrators to arbitrate multiple consolidated claims and makes them the final decision-makers as to whether claims may be arbitrated jointly. Schwab's Waiver expressly deprives the arbitrators of any ability to "consolidate" multiple claims in arbitration.[61] On its face, the Waiver "limits" and "contradicts" Arbitration Rule 12312 in violation of Rule 2268(d)(1).

That FINRA arbitrators are empowered to determine whether to arbitrate on a consolidated basis is confirmed by examination of the history of consolidation in FINRA arbitration. The predecessor to Rule 12312, Rule 10314, also provided that once an arbitration

[61] The term "consolidate" refers to the joining together of separate claims. *See Davey v. First Command Financial Services, Inc.*, 2010 U.S. Dist. LEXIS 10483, at *8 (N.D. Tex. 2010) ("The very first dictionary definition of the word consolidate is 'to join together (as two or more items into one unit or whole)'").

panel was appointed, it had authority to make final determinations with respect to joinder, consolidation and multiple parties. When NASD proposed the 2007 amendments restructuring and rewriting its Arbitration Rules, it commented in support that the proposed Rules relating to joinder were not intended to differ in substance from the predecessor Rule.[62] In approving the 2007 amendments, the SEC reiterated that an arbitration panel has authority to reconsider whatever the Director has done with respect to consolidation of claims.[63] This is consistent with the way earlier versions of the Arbitration Rules were interpreted. As a court said, in holding that consolidation issues are procedural issues for the arbitrators to decide, "[T]he *final* power to make any decisions as to joinder, consolidation and multiple parties is vested by [NYSE] Rule 612(d)(4) in the arbitration panel that is actually assigned to decide the parties' disputes."[64]

Notably, consolidation and joinder serve the interests of the forum as well as the parties, by allowing the forum to treat similar claims and issues efficiently and consistently in a single proceeding. Rule 12312, like Rule 20 of the Federal Rules of Civil Procedure, provides for permissive joinder,[65] which is generally encouraged where there is a substantial relationship between the transactions or occurrences at issue in the interest of judicial economy[66] under

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[62] Order Approving Proposed Rule Change and Amendments, Exchange Act Rel. No. 55158, 2007 SEC LEXIS 141 (Jan. 24, 2007).

[63] *Id.*

[64] *Merrill Lynch, Pierce, Fenner & Smith v. Barchman*, 916 F. Supp. 845, 857 (N.D. Ill. 1996) (interpreting a predecessor of Rule 12312).

[65] Rule 12314, which authorizes the Director of Arbitration to combine claims even if the parties have not submitted them jointly, similarly has a corresponding provision in the Federal Rules of Civil Procedure, Rule 42(a). Rule 42(a) gives a court broad discretion to join claims together when common issues of law or fact, regardless whether the parties seek or object to consolidation. *See Connecticut General Life Ins. Co. v. Sun Life Assur. Co. of Canada*, 210 F.3d 771 (7th Cir. 2000); *Disher v. Citigroup Global Markets, Inc.*, 486 F. Supp. 2d 790 (S.D. Ill. 2007). Thus, consolidation, unlike class actions, and consistent with the FAA, is focused on what makes sense from the perspective of the forum and what will serve the goal of streamlining the resolution disputes.

[66] *See, e.g., Mosley v. General Motors Corp.*, 497 F.2d 1330, 1333 (8th Cir. 1974) ("[A]ll reasonably related claims for relief by or against different parties [should] be tried in a single proceeding.").

different standards than for certifying a class action under Rule 23.[67] By depriving FINRA arbitrators of the flexibility to determine for themselves whether consolidation would be appropriate in a particular case, the Waiver conflicts with FINRA's own policy determination regarding the conduct of the arbitration proceeding, *i.e.*, that consolidation should be available in appropriate cases and that the arbitrators are in the best position to make the ultimate decision regarding consolidation.

(3) ***Schwab's Arguments Against Finding That The Waiver Specifically "Limits" And "Contradicts" Arbitration Rule 12312, Are Unpersuasive***

Schwab's arguments against finding a specific conflict with Arbitration Rule 12312 are unpersuasive. Schwab mainly argues that there is no "limitation" or "contradiction" within the meaning of Rule 2268(d)(1) because, under Schwab's reading of the Waiver, customers retain the ability to submit their claims jointly and the Director of Arbitration retains the ability to separate or join claims. The argument has no merit. Regardless of what the claimants and the Director of Arbitration may do, the Waiver nevertheless is written to deprive arbitrators of some power – and that is a "limitation" or "contradiction" of the Rule. Moreover, depending on one's interpretation of the Waiver, the limitation on the arbitrators' powers may affect the availability of consolidation. If the Waiver deprives arbitrators of any power at all to proceed on a consolidated basis, then permitting claimants to submit claims jointly would be a futile act. If the Waiver deprives arbitrators only of the power to determine whether claims are appropriate for consolidation despite a different determination by the Director, then the Waiver takes away from the arbitrators the flexibility to proceed in the manner they think best. Schwab's argument also fails to recognize the likely effect of the Waiver on customers, who are less likely to attempt

[67] *See, e.g., Lee v. Cook County*, 635 F.3d 969, 971 (7th Cir. 2011) (permissive joinder, unlike a class action, does not require that common question predominate).

to join or consolidate claims when the agreement provides that arbitrators have no power to consolidate claims. Furthermore, even if customers request consolidation, if their interpretation of the effect of the Waiver is different than Schwab's, then further costly and inefficient litigation may be required to resolve the precise meaning and effect of the consolidation language in the Waiver.

Schwab further argues that the term "consolidate" should be interpreted in accord with what Schwab represents was its intent in drafting the Waiver. It says that this language was intended to prevent arbitrators from forming class actions in arbitration by the "roundabout method of" joining multiple claims.[68] However, the express language of the provision, which does not mention class actions, does not support the construction Schwab gives the provision. Importantly, Schwab's purported prohibition on the arbitrators creating class actions is unnecessary. FINRA already has a Rule prohibiting class actions in arbitration, Rule 12204(a). If arbitrators were to attempt to create a class action in arbitration, Schwab would always have the right to object that the arbitrators have no such authority under the Arbitration Rules.

Schwab also argues that the consolidation language is not a violation because Schwab "does not intend to apply this provision in any manner to limit the power of arbitrators or the Director [of Arbitration] with respect to combining claims that have been validly submitted to FINRA arbitration by customers."[69] Whether the Waiver conflicts with and violates FINRA's Rules cannot turn on how Schwab might enforce the provision in the future, and certainly it cannot turn on Schwab's determination as to whether claims have been "validly submitted" as consolidated claims. Schwab's Waiver must be interpreted as written. The courts consistently

[68] Schwab Motion at 29.

[69] Schwab Motion at 30.

hold that the words of a contract, including an arbitration agreement, "must be given their usual and ordinary meaning."[70]

Schwab's Waiver cannot be harmonized with the unambiguous language and operation of Rule 12312. The Waiver violates FINRA Rule 2268(d)(1).[71] Again, however, the question arises whether the FAA applies, and, if so, whether the statute forecloses FINRA from enforcing its Rules regarding consolidation.

IX. THE FEDERAL ARBITRATION ACT APPLIES HERE AND FORECLOSES FINRA FROM ENFORCING RULES THAT WOULD ALLOW CUSTOMERS TO AVOID GOING TO ARBITRATION

A. The FAA Applies

The FAA applies to Schwab's agreement because Section 2 of the FAA expressly states that the Act applies to every written agreement to arbitrate contained in a contract "evidencing a transaction involving commerce."[72] Schwab's Arbitration Agreement is an agreement involving transactions in commerce.

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[70] *See Davey*, 2010 U.S. Dist. LEXIS 10483, at *8 *(quoting Robin v. Sun Oil Co.*, F.2d 554, 557 at 7 (5th Cir. 1997)).

[71] As written, the attempt to limit the powers of the arbitrators may also conflict with FINRA Rule 2268(a)(7), which provides that the rules of the arbitration forum are incorporated into a member's pre-dispute arbitration agreement, along with any *amendments*. The limitation on the power of arbitrators to join or consolidate claims might be interpreted as an agreement to fix permanently the powers of the arbitrators, regardless of later amendments. Language agreeing to limit the powers of the arbitrators is inconsistent with the fundamental principle that FINRA develops Rules, including the Arbitration Rules regarding the powers of FINRA arbitrators, through the rulemaking process.

This conflict with FINRA Rule 2268 (a)(7) arises not only in connection with the consolidation language but also with respect to Schwab's attempt to limit the authority of FINRA arbitrators "to proceed on a representative or class action basis." While this language does not conflict with FINRA's current Rules regarding class actions, it is an impermissible attempt to fix permanently, by agreement, the powers of FINRA arbitrators, regardless of any future modifications of FINRA's Rules.

[72] 9 U.S.C. § 2; *Concepcion*, 2011 U.S. LEXIS 3367, at ***10.

Even aside from the statute, Schwab's customer agreements themselves expressly state that the FAA governs Schwab's Arbitration Agreements.[73] This language evidences the intent of the Parties to apply the FAA to Schwab's Arbitration Agreements. That such language has long been included in Schwab's customer agreements without objection by FINRA, also suggests, given FINRA's close regulation of what can and cannot be included in a member firm's customer agreements, that FINRA has understood the FAA to apply to such agreements. Finally, courts have recognized that FINRA's Arbitration Rules themselves constitute an agreement to arbitrate that is covered by the FAA, even separate from a customer-member agreement.[74] Accordingly, the incorporation of FINRA's Arbitration Rules into Schwab's Arbitration Agreements only confirms that the FAA is applicable.

B. The FAA Requires A Party To An Arbitration Agreement To Go To Arbitration, Despite Any Countervailing Policy Concerns – Unless Congress Itself Has Created An Exception To The FAA

The Supreme Court has repeatedly held that the FAA requires a party to an arbitration agreement to go to arbitration to resolve any claim covered by the agreement, unless Congress – and Congress alone – has created an exception to the FAA. As the Court explained in *Shearson*,[75] the FAA "mandates enforcement of agreements to arbitrate statutory claims" unless "overridden by a contrary *congressional* command."[76] The Court further declared that "[t]he

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[73] See note 44 above.

[74] *See, e.g., Washington Square Sec., Inc. v. Aune*, 385 F.3d 432, 435 (4th Cir. 2004) (NASD Code constitutes an agreement under the Federal Arbitration Act that binds a member to submit an eligible dispute to arbitration, regardless of whether there is a signed customer agreement to arbitrate). *See also Morgan Keegan & Co. v. Silverman*, 2013 U.S. App. LEXIS 2412, *3-4 (4th Cir. Feb. 4, 2013) ("[I]n the absence of a separate arbitration agreement, a party can compel a FINRA member to participate in FINRA arbitration if [the party is a customer of the FINRA member or an associated person of the FINRA member and the dispute involves their business activities].").

[75] *Shearson*, 482 U.S. 220, 226.

[76] *Id.* (emphasis supplied).

burden is on the party opposing arbitration ... to show that *Congress* intended to preclude a waiver of judicial remedies for the statutory rights at issue .... If *Congress* did intend to limit or prohibit waiver of a judicial forum for a particular claim, such an intent 'will be deducible from [the statute's] text or legislative history,' ... or from an inherent conflict between arbitration and the statute's underlying purposes."[77]

In *Concepcion*, where the Court held that the FAA preempted the California state law doctrine known as the *Discover Bank* rule, the Court made plain that no state policy against arbitration can supersede Congress's statute favoring arbitration. The Court said, "When state law prohibits outright the arbitration of a particular type of claim, the analysis is straightforward:

[77] *Id.* at 227 (emphasis supplied). The Court reiterated that only Congress can create an exception to the FAA, concluding that parties arguing that they should be allowed to go to court despite their agreement to arbitrate have the burden of "demonstrat[ing] that *Congress* intended to make an exception to the Arbitration Act for claims arising under RICO and the Exchange Act, an intention discernible from the text, history, or purposes of the statute." *Id.* (emphasis supplied).

The conflicting rule is displaced by the FAA."[78] It further reiterated, "[O]ur cases place it beyond dispute that the FAA was designed to promote arbitration. They have repeatedly described the Act as 'embod[ying] [a] national policy favoring arbitration.'"[79]

In the short time since the Supreme Court's decision in *Concepcion*, the Court has four more times expressly reiterated that the FAA establishes a "federal policy in favor of arbitral dispute resolution."[80] These decisions instruct that claims subject to an arbitration agreement

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[78] *Concepcion* at ***13-14.

[79] *Id.* at ***21. The Ninth Circuit has read *Concepcion* to mean that "unrelated policy concerns, however worthwhile, cannot undermine the FAA." *Coneff v. AT&T Corp.*, 673 F.3d 1155, 1159 (9th Cir. Mar. 16, 2012). According to that Court of Appeals, federal preemption *requires* that state law bend to conflicting federal law – no matter the purpose of the state law. Indeed, the Ninth Circuit could not have been more direct when it said in another case, "Although [a rule requiring judicial resolution of a claim rather than arbitration] may be based upon the sound public policy judgment of the California legislature, we are not free to ignore *Concepcion's* holding that state public policy cannot trump the FAA when that policy prohibits the arbitration of a 'particular type of claim.'" *Kilgore v. Keybank, N.A.*, 673 F.3d 947, 963 (9th Cir. Mar. 7, 2012).

See also Miguel v. JPMorgan Chase Bank, N.A., 2013 U.S. Dist. LEXIS 16865, at *6 (C.D. Cal. Feb. 5, 2013) (compelling arbitration of California labor law claims, and stating: "[T]he FAA mandates that district courts *shall* direct the parties to proceed to arbitration on issues as to which an arbitration agreement has been signed."). In *Miguel*, the district court expressly declared "[T]he Ninth Circuit [has] interpreted the Supreme Court's holding in *Concepcion* to mean that banning class action waivers would be inconsistent with the FAA." *Id.* at *19.

Where confronted with the contention that a class action waiver is unenforceable as contrary to public policy, "the overwhelming majority of courts have enforced class action waivers." *Credit Acceptance Corp. v. Davisson*, 644 F. Supp. 2d 948, 959 (E.D. Ohio 2009). *See also Luchini v. Carmax, Inc.*, 2012 U.S. Dist. LEXIS 102198, at *10-11 (E.D. Cal. July 23, 2012) ("In enacting § 2 of the [FAA], Congress declared a national policy favoring arbitration and withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration."). "[A]rguments asserting the importance of maintaining the availability of class actions" are policy concerns that "cannot undermine the FAA." *Brokers' Services Marketing Group v. Cellco Partnership d/b/a Verizon Wireless*, 2012 U.S. Dist. LEXIS 42721, at *12-13 (D.N.J. Mar. 28, 2012) (Not for Publication).

[80] *Nitro-Lift Technologies, L.L.C. v. Howard*, 568 U.S. __, 133 S. Ct. 500, 503 (Nov. 26, 2012) (*per curiam*) (The FAA "declare[s] a national policy favoring arbitration") (*quoting Southland Corp. v. Keating*, 465 U.S. 1, 10 (1984)); *Marmet Health Care Center v. Brown*, 565 U.S. __, __, 132 S. Ct. 1201, 1203 (Feb. 21, 2012) (The FAA "reflects an emphatic federal policy in favor of arbitral dispute resolution") (*quoting Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 631 (1985) and *Moses H. Cone Memorial Hospital v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1983)); *Compucredit Corp. v. Greenwood*, 132 S. Ct. 665, at *669; 2012 U.S. LEXIS 575, at *5 (Jan. 10, 2012) (Section 2 of the FAA establishes "a liberal federal policy favoring arbitration agreements"); *KPMG LLP v. Cocchi*, 565 U.S. __, __, 132 S. Ct. 23, 25 (Nov. 7, 2011) (*per curiam*) ("The Federal Arbitration Act reflects an 'emphatic federal policy in favor of arbitral dispute resolution.'") (*quoting Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 631 (1985)).

covered by the FAA must be sent to arbitration for resolution, and that countervailing policy concerns cannot override that mandate.

Like *Concepcion*, three of the recent cases involved the application of the FAA to override state law policy concerns. In *KPMG LLP v. Cocchi*,[81] for example, the Court expressly declared that arbitrable claims must be arbitrated "even where the result would be the possibly inefficient maintenance of separate proceedings in different forums."[82] The Court thus vacated and remanded a Florida state court decision refusing to compel arbitration of two claims because two other related claims were not subject to arbitration. In *Marmet Health Care Center v. Brown*,[83] the Court held that pre-dispute arbitration agreements in connection with personal injury and wrongful death claims against nursing homes must be enforced pursuant to the FAA despite a state court ruling that such arbitration agreements were unenforceable as a matter of public policy under West Virginia law. Citing *Concepcion*, the Supreme Court stated that a prohibition on arbitration of a particular type of claim is contrary to the FAA, and the FAA "displaced" the contrary state law.[84] In *Nitro-Lift Technologies, L.L.C. v. Howard*, the Court vacated an Oklahoma court decision holding non-compete agreements unenforceable under Oklahoma law because the employee contract contained valid arbitration agreement and the FAA

[81] *KPMG LLP v. Cocchi*, 565 U.S. __, 132 S. Ct. 23 (Nov. 7, 2011) (*per curiam*).

[82] *Id.* at 26.

[83] *Marmet Health Care Center v. Brown*, 565 U.S. ___, 133 S. Ct. 500 (Feb. 21, 2012).

[84] *Id.* at 504.

required that the issue be resolved by arbitration. The Court said that the Oklahoma court "must abide by the FAA, which is 'the supreme Law of the Land,' U.S. Const., Art. VI, cl. 2, and by the opinions of this Court interpreting that Law."[85]

The fourth recent decision, *Compucredit Corp. v. Greenwood*,[86] demonstrates that the same analysis applies in the context of federal statutory claims. That case involved the Credit Repair Organizations Act ("CROA"). The Court declared that the FAA governs "even when the claims at issue are federal statutory claims, unless the FAA's mandate has been 'overridden by a contrary congressional command.'"[87] The Court found no contrary congressional command in CROA even though that statute created a "right to sue" for violations of CROA and a "nonwaiver" provision as to any "right." The Court described the "right to sue" as a term contemplating the ability to bring a claim and not a limitation on the forum where the claim could be brought. The Court held, "Because the CROA is silent on whether claims under the Act can proceed in an arbitrable forum, the FAA requires the arbitration agreement to be enforced according to its terms."[88]

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[85] *Nitro-Lift*, 568 U.S. ___, ___, 133 S. Ct. 500, 503 (Nov. 26, 2012).

[86] *Compucredit Corp. v. Greenwood*, 565 U.S. ___, 132 S. Ct. 665 (Jan. 10, 2012).

[87] *Id.* at 669 *(quoting Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 226 (1987)).

[88] *See Owen v. Bristol Care, Inc.*, 702 F.3d 1050, 1055 (8th Cir. Jan. 7, 2013) ("[G]iven the absence of any 'contrary congressional command' from [the Fair Labor Standards Act] that a right to engage in class actions overrides the mandate of the FAA in favor of arbitration, we reject [the assertion that class action waivers are unenforceable with respect to FLSA claims.]"); *Jasso v. Money Mart Express, Inc.*, 879 F. Supp. 2d 1038, 2012 U.S. Dist. LEXIS 52538, at *26 (N.D. Cal. Apr. 13, 2012) (*Compucredit* demonstrates that the Supreme Court's "statement of the meaning and purposes of the FAA [in *Concepcion*] applies equally in the context of determining which federal statute controls").

Similarly see King v. Capital One Bank (USA), N.A., 2012 U.S. Dist. LEXIS 163562, at *27-34 (W.D. Va. Nov. 15, 2012), where the Court concluded that CROA does not provide a nonwaivable right to bring a class action. The plaintiff in that case had argued that a class action was a "protection" that CROA preserved from waiver. Based on *CompuCredit*, the Court rejected the argument. It said, "[T]he mere fact that the statute mentions a particular concept or procedure does not mean that such concept or procedure is a "right" or "protection" that cannot be waived." *Id.* at *32.

Thus, the Supreme Court has consistently held that the mandate of the FAA cannot be overridden by other policy makers. Only Congress can create an exception to the FAA.[89]

That FINRA's Rules are in issue here instead of state or federal statutes or regulations does not make a difference. FINRA promulgates its Rules pursuant to delegated authority from the SEC and subject to the SEC's oversight and approval, as part of its mission to protect investors and promote market integrity. While the Rules have the force and effect of federal

[89] The Hearing Panel recognizes that, despite the Supreme Court decisions discussed above, the interplay of arbitration and class actions remains controversial. The Second Circuit, for example, refused for the third time to enforce a class action waiver after considering briefing on the impact of *Concepcion*, and a sharply divided court of appeals declined to reconsider the panel's decision *en banc*, with both a concurring and a dissenting opinion. *See In re American Express Merchants' Litig., Italian Colors Restaurant v. American Express Trav. Related Servs. Co.*, 667 F.3d 204, 219 (2d Cir. Feb. 1, 2012) ("*Amex III*"), *reh'g en banc denied*, 681 F.3d 139, 2012 U.S. App. LEXIS 10815 (2d Cir. May 29, 2012). The *Amex III* panel held that a class action waiver in an arbitration agreement is not enforceable if the practical effect would be to preclude the plaintiffs' ability to vindicate federal statutory rights. *See also In re Electronic Books Antitrust Litig.*, 2012 U.S. Dist. LEXIS 90190 (S.D.N.Y. June 27, 2012) (arbitration clauses held unenforceable where high cost of pursuing antitrust claims individually was so prohibitive that individuals could not vindicate their rights under the federal antitrust laws). The Supreme Court has granted *certiorari* to review the decision in *AMEX III*. *American Express Co. v. Italian Colors Restaurant*, No. 12-133, 568 U.S. __, 133 S. Ct. 584 (Nov. 9, 2012) (paraphrase of question presented: whether courts may invalidate an arbitration agreement because it does not allow class arbitration of federal statutory claim) (oral arg. scheduled Feb. 27, 2013).

The Hearing Panel doubts that *AMEX III* can stand in the face of *Concepcion* and subsequent Supreme Court decisions, but, in any event, the theory of *AMEX III* would not provide a basis for holding here that judicial class actions must be preserved as a customer option. A holding based on that theory would require a finding that SRO arbitration is insufficient to protect investors' substantive rights, a finding that would fly in the face of decades of judicial, legislative, and regulatory history endorsing the securities industry arbitration system.

regulation and may preempt state law,[90] FINRA's Rules can only be enforced to the extent that they are not inconsistent with federal law.[91] Federal law includes the FAA. Accordingly, FINRA's Rules may not be enforced to the extent they are inconsistent with the FAA, unless *Congress* has created a relevant exception.[92]

C. Congress Has Created No Exception To The FAA That Would Bar Arbitration Of Schwab Customer Claims Or Require The Availability Of Judicial Class Actions

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. The Hearing Panel concludes that Congress has created no such exception.

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[90] *See Credit Suisse First Boston v. Grunwald*, 400 F.3d 1119, 1128-32 (9th Cir. 2005) (where the Court held that SRO Rules approved by the SEC, including specifically Arbitration Rules, preempt state law when the two are in conflict. *See also McDaniel v. Wells Fargo Investments, LLC*, 2011 U.S. Dist. LEXIS 79975, at *5-7 (N.D. Cal. July 22, 2011) (Securities Exchange Act created a system of self-regulation in which SROs are the primary regulators of securities broker-dealers and use delegated government power to promulgate Rules and enforce compliance); *Heilimann v. Bank of America Corp.*, 2011 U.S. Dist. LEXIS 68155, at *4 (N.D. Cal. 2011) (NYSE Rule may have same preemptive effect as a federal statute or regulation); *Bloemendaal v. Morgan Stanley Smith Barney LLC*, 2011 U.S. Dist. LEXIS 61772, at *22-23 (N.D. Cal. 2011) (SROs have been delegated government power to enforce compliance with both the Exchange Act and ethical standards going beyond those requirements).

[91] *See Tuan Thai v. Ashcroft*, 366 F.3d 790, 798 (9th Cir. 2004) (federal regulation cannot do what federal statute forbids); *In re Watson v. Proctor*, 161 F.3d 593, 598 (9th Cir. 1998) ("A federal regulation in conflict with a federal statute is *invalid* as a matter of law.").

[92] Recent developments in the field of labor relations law highlight the need to find a contrary congressional command in order to invalidate an agreement to arbitrate that eliminates class, collective, or representative actions. The NLRB has taken the position that the statute it administers overrides the FAA, but courts have concluded that the National Labor Relations Act does not contain a clear congressional command to override the FAA. *Compare In re D.R. Horton, Inc.*, 2012 NLRB LEXIS 11 (Jan 3, 2012) (on appeal to the Fifth Circuit) (invalidating class action waiver in employer-employee agreement) *with Delock v. Sec. Services USA, Inc.*, 2012 U.S. Dist. LEXIS 107117, at *5-6, 10 (E.D. Ark. Aug. 1, 2012) (noting "unmistakable" trend in the law to enforce arbitration agreements unless "overridden by a contrary congressional command."). *See also Torres v. United Healthcare Services, Inc.*, 2013 U.S. Dist. LEXIS 14200, *24-25 (E.D.N.Y. Feb. 1, 2013) (NLRB's interpretation of FAA is outside its expertise and not entitled to deference); *Noffsinger-Harrison v. LP Spring City, LLC*, 2013 U.S. Dist. LEXIS 16442 (E.D. Tenn. Feb. 7, 2013) (labor relations statute (Norris-LaGuardia Act) did not repeal FAA or render arbitration agreement unenforceable); *Neil C. Andrus v. D.R. Horton, Inc.*, 2012 U.S. Dist. LEXIS 169687, at *21 (D. Nev. Nov. 5, 2012) ("The Federal Arbitration Act ("FAA") requires courts to compel arbitration of any controversy covered by the terms of a valid written agreement to arbitrate."); *Oliveira v. Citicorp North America, Inc.*, 2012 U.S. Dist. LEXIS 69573, at *6-7 (M.D. Fla. May 18, 2012) (collecting cases).

See also Walton v. Rose Mobile Homes LLC, 298 F.3d 470, 479 (5th Cir. 2002) and *Davis v. Southern Energy Homes Inc.*, 305 F.3d 1268, 1275 (11th Cir. 2002) (finding no congressional intent to except Magnuson-Moss Warranty Act claims from the FAA).

Enforcement has identified nothing in the securities laws that would give FINRA's Rules priority over the FAA. Nor has Enforcement identified any congressional intent to preserve judicial class actions as an option in customer securities claims even where there is a predispute arbitration agreement. To the contrary, judicial precedents point in the opposite direction. The Supreme Court has already held that under the FAA securities claims under the Exchange Act (in *Shearson*) or the Securities Act (in *Rodriguez*) must go to arbitration if they are covered by a pre-dispute arbitration agreement. Furthermore, as made plain in *Concepcion, Marmet*, and other Supreme Court decisions, arbitration is generally favored over judicial class actions as a simpler, more efficient means of resolving disputes. In *CompuCredit* the Court expressly stated, "Requiring the availability of classwide arbitration interferes with fundamental attributes of arbitration and thus creates a scheme inconsistent with the FAA."[93]

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. Rather, the Rule represents only a determination by FINRA, pursuant to its general authority to promulgate Rules, to make an exception to the FAA. FINRA's general authority to promulgate Rules is not a *congressional* command to promulgate the *particular* Rule carving out an exception to the FAA.

In sum, the Hearing Panel concludes that the FAA requires that Schwab's Waiver be enforced to require customers to go to arbitration and that any FINRA policy determination that judicial class actions should remain available to customers must give way to the FAA's mandate.

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[93] *Concepcion*, 131 S. Ct. 1740, 1748.

X. THE FEDERAL ARBITRATION ACT DOES NOT BAR FINRA FROM ENFORCING ITS RULES REGARDING THE POWERS OF FINRA ARBITRATORS OR JOINDER AND CONSOLIDATION

The FAA does not specify that arbitrators should have specified powers or that arbitration must follow a particular procedure, although, as noted above, the Supreme Court has expressed the view that class actions are inconsistent with the underlying purpose of the FAA to streamline the resolution of disputes. As the Supreme Court first explained in *Volt Info. Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.*[94] and later reiterated in *Mastrobuono v. Shearson Lehman Hutton, Inc.*,[95] the FAA does not require that arbitration agreements follow any particular rules or procedures. Rather, it requires that parties arbitrate if they agreed in writing to arbitrate; and it requires the federal courts to send matters to arbitration if those matters are subject to an arbitration agreement.

Once it is clear that a particular dispute falls within the scope of an arbitration agreement, procedural questions regarding how the arbitration should proceed are determined by the arbitrators.[96] The Supreme Court made this point clear in *Howsam v. Dean Witter Reynolds, Inc.*,[97] where it held that interpretation of an NASD Arbitration Rule concerning a six-year eligibility limit was an issue to be determined by the arbitrators, not a court. The Court said, "[P]arties to an arbitration contract would normally expect a forum-based decisionmaker to decide forum-specific procedural gateway matters."[98] The Court reiterated the point in *Green*

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[94] *Volt Info. Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 476, 479 (1989).

[95] *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 57 (1995).

[96] *Dockser v. Schwartzberg*, 433 F.3d 421, 426-27 (4th Cir. 2006). *See also SAL Financial Services, Inc. v. Nugent*, 2007 U.S. Dist. LEXIS 17441 (N.D. Tex. 2007) (interpretation and application of NASD arbitration rules was for NASD arbitration panel).

[97] *Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79 (2002).

[98] *Id.* at 86.

Tree Fin. Corp. v. Bazzle, where it held that arbitrators should decide whether class arbitration was permitted by the arbitration agreement in issue. The Court said, "The question here – whether the contracts forbid class arbitration – ... concerns neither the validity of the arbitration clause nor its applicability to the underlying dispute between the parties.... It concerns contract interpretation and arbitration procedures." The Court concluded that that type of question is for the arbitrators to decide.[99]

The lower courts have specifically held that the issue whether to consolidate individual claims is a procedural issue concerning how an arbitration will be conducted.[100] For example, relying on *Howsam*, the Seventh Circuit declared in *Employers Ins. Co. of Wausau v. Century Indemnity Co.*, "[P]rocedural issues are presumptively for the arbitrator to decide. Consolidation is a procedural issue."[101]

Accordingly, nothing in the FAA prohibits FINRA from authorizing arbitrators to consolidate multiple claims or prohibits FINRA from barring members from specifying different procedures that conflict with FINRA Rules.

In fact, consolidation – in contrast to class action procedure – is consistent with the goals of the FAA, because consolidation concerns considerations of efficiency and streamlined resolution of similar issues. Consolidation – unlike class action procedure – does not involve

[99] *Green Tree Fin. Corp. v. Bazzle*, 539 U.S. 444, 453 (2003).

[100] *Certain Underwriters at Lloyd's London v. Westchester Fire Ins. Co.*, 489 F.3d 580, 587 (3d Cir. 2007).

[101] *Employers Insurance Co. of Wausau v. Century Indemnity Co.*, 443 F.3d 573, 581 (7th Cir. 2006).

complex issues of notice and fairness to absent parties. As the district court in *Markel Int'l Ins. Co. v. Westchester Fire Ins. Co.*,[102] recognized, "[P]rinciples of efficiency strongly favor a single arbitration panel's determination of whether consolidation is appropriate [under the agreements in issue]." The ability of the forum to consolidate when appropriate and to clarify in a consistent way the applicable law contributes to FINRA's ability to perform its regulatory mission and protect investors.

Indeed, it is the highly regulated nature of securities industry arbitration that contributed to the Supreme Court's decision in *Shearson* that securities law claims under the Exchange Act are subject to the FAA. The Court explained that "the mistrust of arbitration that formed the basis" for its earlier jurisprudence on arbitration was "difficult to square with the assessment of arbitration that has prevailed since that time," and that this was "especially so in light of the intervening changes in the regulatory structure of the securities laws."[103] The Court emphasized the SEC's "expansive power to ensure the adequacy of the arbitration procedures employed by the SROs" as a result of 1975 amendments to the Exchange Act.[104] It concluded, "In short, the 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 of any rules it deems necessary to ensure that arbitration procedures adequately protect statutory rights."[105] To permit FINRA members like Schwab to write themselves out of FINRA's Rules would undercut the

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[102] *Markel Int'l Ins. Co. v. Westchester Fire Ins. Co.*, 442 F. Supp. 2d 200, 204 (N.D.N.J. 2006) (consolidation is a procedural issue to be resolved by the arbitrators). *See also Twist v. Arbusto*, 2007 U.S. Dist. LEXIS 42337 (S.D. Ind. 2007) (consolidation is a procedural issue to be resolved by the arbitrators).

[103] *Shearson*, 482 U.S. 220, 233.

[104] *Id.*

[105] *Id.* at 233-234.

basis for the decision in *Shearson* that arbitration does not deprive customers of substantive protections under the securities laws.

XI. SANCTIONS

There are no specific FINRA Sanction Guidelines ("Sanction Guidelines") applicable here.[106] Enforcement argues that the Hearing Panel should be mindful of General Principle No. 1 of the Sanction Guidelines,[107] which provides that "sanctions are to remediate misconduct by preventing the recurrence of misconduct, improving overall standards in the industry, and protecting the investing public."[108] Importantly, a FINRA sanction is intended to "remediate" misconduct, not just by deterring the particular respondent from future misconduct, but by deterring others in the industry from engaging in similar misconduct and improving overall business conduct. Enforcement argues that the violation is "on a very large scale" because Schwab has inserted the Waiver into nearly seven million customer agreements.[109] Enforcement also highlights that Schwab's introduction of the Waiver was a deliberate action, rather than accident or inadvertence.[110] Enforcement initially requested a fine of $10 million in the aggregate, a censure, and an Order requiring Schwab to correct its Waiver to the extent that it violates FINRA's Rules.[111] In briefing on the appropriate sanction for the violation alleged in

[106] FINRA Sanction Guidelines (2011), available at www.finra.org/oho (then follow "Enforcement" hyperlink to "Sanction Guidelines").

[107] Oral Arg. Tr. at p. 51.

[108] Sanction Guidelines, General Principle No. 1, at p. 2.

[109] Enf. Motion at 25-26; Oral Arg. Tr. at 40, 50-51.

[110] Enf. Motion at 26.

[111] Enf. Motion at 28-29.

Cause Three, Enforcement repeated its request for a correction and a censure, but reduced the requested fine to $500,000.[112]

Schwab argues that if a violation is found it does not warrant more than a direction to correct the Waiver. Schwab believes that there has been insufficient notice to members that class-action waivers like the one adopted by Schwab violate FINRA Rules.[113] Schwab also contends that it acted in "good faith" upon an interpretation of FINRA's Rules in light of the Supreme Court's decision in *Concepcion* and subsequent judicial developments.[114] Finally, Schwab asserts that no customers were harmed by its actions in amending its customer agreements.[115]

The Hearing Panel focuses on the precise nature of the violation – an attempt to circumscribe the powers of FINRA arbitrators. With that in mind, the Hearing Panel finds that four factors weigh in favor of a substantial sanction.

First, the Hearing Panel rejects Schwab's contention that there has been insufficient notice that it is a violation of FINRA's Rules to attempt to circumscribe the powers of FINRA arbitrators. FINRA's Rules clearly insist on compliance with the Rules, as they may be amended from time to time, and FINRA's Arbitration Rules clearly grant and circumscribe the powers of FINRA arbitrators. Moreover, FINRA plainly gives its arbitrators the final word on whether a matter may go forward on a consolidated basis.

Second, Schwab overreached when it attempted to circumscribe the powers of the arbitrators. It introduced language into its customer agreements that directly contradicts

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[112] Enf. Sanctions Br. at 5-7.

[113] Oral Arg. At 68-69.

[114] Resp. Sanctions Br. at 4.

[115] Resp. Sanctions Br. at 7-8.

unambiguous Rules governing the authority of FINRA arbitrators and the procedures for consolidation in particular. This overreaching was unnecessary, even if it was intended only to ensure that no claims would be arbitrated as class actions. FINRA already prohibits the arbitration of class actions in its forum.

Third, Schwab may have acted in "good faith" in the sense that it focused on the evolution of Supreme Court jurisprudence relating to judicial class actions when drafting and issuing its Waiver, but it failed to recognize that nothing in that jurisprudence supports the elimination of consolidation as an arbitration procedure. Furthermore, in focusing on the language of class action waivers outside the context of the highly regulated securities industry, Schwab disregarded its particular responsibility to comply with FINRA Rules. While an unregulated entity may draft its arbitration agreements as it pleases, subject only to the FAA and judicial interpretations of that statute, a regulated entity must also look to the rules particularly governing its arbitration agreements.

Fourth, it is important to deter Respondent and others from rewriting their arbitration agreements in ways that challenge the authority of FINRA to promulgate Arbitration Rules for the industry as a whole. Compliance with Rules promulgated pursuant to the SEC's detailed oversight in the rulemaking process is essential to FINRA's ability to perform its self-regulatory duties and investor protection mission. Members' customer agreements, including their arbitration agreements, must be consistent with industry-wide requirements.

On balance, the Hearing Panel concludes that both corrective action and a fine of $500,000 are appropriate. The Hearing Panel does not impose a censure because it believes the corrective action and fine to be sufficiently remedial.

XII. CONCLUSION AND ORDER

The Hearing Panel finds that the remedial purposes of FINRA sanctions require that Schwab be **ORDERED** to do the following: (i) cease using the portion of the Waiver purporting to delimit the authority of the arbitrators and complete the process of removing that language from customer agreements and account applications; (ii) notify in writing all current customers and any former customers who received the Waiver (in language consistent with this decision) that the prior limitation on the powers of arbitrators is not effective; (iii) notify and reiterate to all current customers and any former customers who received the Waiver that Schwab's agreement to arbitrate includes an agreement to arbitrate subject to FINRA Arbitration Rules, as amended from time to time, and, in particular, that consolidation is available in arbitration; (iv) pay a fine of $500,000; and (v) pay the costs of the non-evidentiary hearing. Those costs are $ 1318.25, which include an administrative fee of $750 and the cost of the transcript. These sanctions shall become effective on a date set by FINRA, but not earlier than 30 days after the date this decision becomes the final disciplinary action in this proceeding by FINRA.[116]

Lucinda O. McConathy
Hearing Officer
For the Hearing Panel

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[116] The Hearing Panel has considered and rejected any arguments of the parties that are inconsistent with this decision.