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NASAA

May 3, 2013

The Honorable Mary Jo White
U.S. Securities & Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: Mandatory Predispute Arbitration Clauses

Dear Chair White:

The North American Securities Administrators Association ("NASAA") has long been concerned with the use of mandatory predispute arbitration clauses in the customer contracts used by broker-dealers and investment advisers. It has been our longstanding position that the "take it or leave it" approach represented by these mandatory clauses is harmful to investors. This belief has led NASAA to urge Congress to curb their use, and Congress heeded our call when it enacted Section 921 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[1] Section 921 provides the SEC the authority, by rule, to prohibit or impose limitations on the use of mandatory arbitration clauses in broker-dealer and investment adviser customer contracts.

The decision by Charles Schwab & Company (Charles Schwab) to include class action waivers in the arbitration provisions of its customer contracts is yet another example of the pernicious effects of mandatory arbitration clauses. Charles Schwab's decision to flaunt FINRA rules prohibiting the use of such clauses coupled with the decision by a FINRA Hearing Panel not to enforce those rules highlights the importance of Section 921. Now, more than ever, it is essential that the SEC use its authority to insure that investors have meaningful remedies and a choice of forums in which to resolve disputes with broker-dealers and investment advisers. The FINRA Hearing Panel issued its decision in a Disciplinary Proceeding against Charles Schwab.[2] Specifically, the Hearing Panel found that provisions in FINRA Rules 2268(d)(1) and (d)(3), which preserve judicial class actions as an alternative to arbitration, could not be enforced because they conflicted with the Federal Arbitration Act (FAA).[3]

Judicial class action litigation in securities disputes serves an important role in the promotion of investor protection and judicial efficiency. The SEC expressly recognized their utility when it adopted the precursor to Rule 2268 wherein the Commission stated "[w]ithout access to class actions in [appropriate] cases, both investors and broker-dealers have been put to the expense of

[1] Codified at 15 U.S.C. §§ 78o and 80b-5.
[2] *See* Dep't of Enforcement v. Charles Schwab & Co., Inc., Disciplinary Proceeding No. 2011029760201.
[3] 9 U.S.C. §§ 1-16 (2006).

wasteful, duplicative litigation…. *The Commission believes that investor access to the courts should be preserved for class actions.*"[4] (Emphasis added). Congress also subsequently acknowledged the importance of judicial class action litigation by declining to eliminate the class action vehicle in the Private Securities Litigation Reform Act of 1995.[5]

FINRA Rules 12204 and 2268(f) require that its arbitration forums refuse claims brought on behalf of a class so that investors can avail themselves of the efficient procedures for judicial class actions. FINRA Rule 2268(d)(3) takes this protection a step further by prohibiting a member from imposing limits on the ability of a party to file a claim, including a judicial class action claim. Implementation of the Hearing Panel Decision would deprive investors of a critically important procedural vehicle designed to address harm suffered by multiple parties.

Judicial policy supports the continued availability of the class action vehicle. The ability of courts to address claims involving common issues of law or fact amongst multiple parties provides an efficient method by which claimants with lesser amounts of alleged losses may seek recovery. The pursuit of these smaller claims would otherwise be economically impractical given the fees and costs associated with litigation, including FINRA arbitration proceedings.[6] Judicial policy is also promoted by providing a medium for resolving common issues of law or fact in a consistent and uniform manner. Absent the class action vehicle, identical or practically indistinguishable claims may be subject to varying and inconsistent outcomes depending on the characteristics of the forum before which they are brought. This result can hardly be squared with the ideals of consistency and uniformity in the application of the rule of law sought by the modern judiciary. As a practical matter, the universal practice by broker-dealers of including mandatory pre-dispute arbitration agreements in all customer agreements has left securities class actions as one of few remaining areas where securities jurisprudence can be developed.

Investor confidence in the integrity of the securities market, and in particular its participants, is also fostered by the preservation of class action litigation. Charles Schwab's attempt to unilaterally alter its account agreements to include the class action waiver is an obvious attempt by the firm to insulate itself from liability to its own clients, which clearly violates public policy and may further violate Charles Schwab's regulatory duty to "observe high standards of commercial honor and just and equitable principles of trade."[7] Recent commentary has suggested that Charles Schwab's desire to waive its own client's class action rights may have been prompted by a $200 million settlement in a recent class action involving one of the firm's

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[4] Order Approving Proposed Rule Change Relating to the Exclusion of Class Actions from Arbitration Proceedings, 57 Fed. Reg. 52659. 52660 (Nov. 4, 1992). *See also*, Nielsen v. Piper, Jaffray & Hopwood, 66 F.3d 145 (7th Cir. 1995) (allowing in investor in an arbitration agreement to file a class action once the NASD rule became effective. The court stated: "But the extent of the 'law' of arbitration was cut back by the SEC when it pronounced that claims which had been previously filed as a class action or were encompassed by a class action were now ineligible for arbitration. In other words, in adopting these rules the SEC placed these types of claims outside the reach of otherwise enforceable arbitration agreements." Id. at 145).

[5] Pub. L. 104-67, 109 Stat. 737.

[6] Indeed, a recent settlement in a federal class action proceeding against Charles Schwab concerning the firm's YieldPlus Fund resulted in an average estimated settlement payment of $881.00. *See* In re Charles Schwab Sec. Litig., No. C08-01510 WHA, 2011 WL 1481424, at *5 (N.D. Cal. Apr. 19, 2011).

[7] FINRA Rule 2010, Standards of Commercial Honor, Amended by SR-FINRA-2008-028 eff. Dec. 15, 2008

mutual funds.[8] The same commentary has opined that the amount of this settlement was far in excess of the likely costs of settling or arbitrating each claim individually.[9]

Attempts by broker-dealers to limit liability to their clients, or otherwise frustrate clients' attempts at obtaining relief, are not a new practice. The National Association of Securities Dealers (the predecessor to FINRA) previously noted several problematic areas of evolution in pre-dispute arbitration clauses in customer agreements.[10] The NASD cautioned its members that clauses which, in their exercise, would tend to frustrate a client's ability to effectively bring a claim in arbitration may be contrary to the then-current NASD Rules of Fair Practice.[11] By extension, the same logic applies equally to class action relief.

As a FINRA member firm since October 13, 1970, Charles Schwab is required to have full knowledge of FINRA rules and is bound to follow them if the firm seeks to maintain its membership. By unilaterally incorporating the waiver into its customer contracts, Charles Schwab chose to defy its own agreement with FINRA. As a law enacted to enforce contractual agreements, the FAA should not be interpreted to endorse this action by Charles Schwab. Although the FAA may give Charles Schwab the right to enforce arbitration agreements entered into by customers, it surely does not prohibit Charles Schwab from giving up some of those rights in its membership agreement with FINRA.

Ironically, the action by Charles Schwab actually thwarts the purposes of the FAA. The "principal purpose" of the FAA was to "require courts to enforce privately negotiated agreements to arbitrate, like other contracts, in accordance with their terms."[12] In the present case, during the first week of October 2011, Charles Schwab attempted to alter the account agreements with the firm's clients by mailing amendments to over 6.8 million account holders.[13] This unilateral action can only be described as the antithesis of the negotiated agreements contemplated by the FAA.

The SEC has clear authority to enact rules designed to insure the fairness of the arbitration process. As noted above, Section 15(o) of the Securities Exchange Act of 1934 provides the SEC with the ability to prohibit, limit or condition agreements that would "require customers or clients . . . to arbitrate any future disputes between them arising under the Federal securities laws, the rules or regulations thereunder, or the rules of a self-regulatory organization," if the

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[8] See Richard P. Ryder, Class Action Waivers and Arbitration Agreements, SECURITIES ARBITRATION COMMENTATOR 1, Oct. 2011.
[9] Id.
[10] Nat'l Ass'n of Sec. Dealers, Inc., Notice to Members 95-16 (Mar. 1995).
[11] Specifically, Section 21(f)(4) of the NASD Rules of Fair Practice, as amended, prohibited the use in any customer agreement of any language that (a) limited or contradicted the rules of the NASD or any other self-regulatory organization; (b) limited the ability of a party to file a claim in arbitration; or (c) limited the ability of the arbitrators to make an award under the arbitration rules of a self-regulatory organization and applicable law.
[12] Volt Info. Scis., Inc. v. Bd. of Trs. of Leland Stanford Junior Univ., 489 U.S. 468, 478 (1989).
[13] Dep't of Enforcement v. Charles Schwab & Co., Inc. (CRD 5393), Disciplinary Proceeding No. 2011029760201, Hearing Panel Decision Granting in Part and Denying in Part the Parties' Cross-Motions For Summary Disposition, page 19 (Feb. 21, 2013).

Commission finds that such a prohibition or limitation is in the public interest and for the protection of investors.[14]

As the agency chosen by Congress to oversee FINRA arbitration, the SEC's exercise of its specific authority supersedes the FAA's general provisions.[15] Regardless of the erroneous decision by the FINRA Hearing Panel, Congress has expressed its clear intent that the SEC is empowered to take action with respect to mandatory predispute arbitration clauses in broker-dealer and investment adviser customer contracts, and the SEC should not permit Charles Schwab to subvert the clear intent of Congress.

If the Hearing Panel's decision is not overturned, there is a good chance that many other brokerage firms will follow suit and also restrict their investors from exercising their rights to participate in class actions. By banning class actions, firms will insulate themselves from not only having to pay damages to investors who have small claims and cannot afford to file, but also to thousands of investors who will never even know they have a cause of action. Arbitration cases are basically secret proceedings, not open to the public, and rarely publicized. The only way many investors learn that they have been defrauded is via a class action notice.

The SEC has broad authority to regulate broker-dealers and investment advisers in order to protect investors. At a minimum, the SEC should not be hesitant to use the authority Congress granted it under Section 15(o) to take the steps necessary to prevent the use of class action waivers that deprive investors of the right to recover for harms they suffer. Preferably, the SEC should ban the use of mandatory pre-dispute arbitration agreements altogether so that investors have a choice when it comes to the forum they want to decide their claims. Whether the forum is a civil proceeding in court or an arbitral proceeding, investors should be free to choose. While NASAA does not oppose arbitration agreements, it believes that such agreements should be entered into at the time the case or controversy arises, not when an account is first opened.

Thank you for the opportunity to comment on this important developing issue. NASAA commends the SEC for taking several steps over the years to improve the arbitration forum and process, and encourages the SEC to take further action to ensure that investors who are forced into arbitration receive the fairest forum possible.

Sincerely,

A. Heath Abshure
President

[14] The House Report accompanying the bill clearly evidences Congress' concern with "securities industry practices [that] have deprived investors of a choice when seeking dispute settlement, too. In particular, pre-dispute mandatory arbitration clauses inserted into contracts have limited the ability of defrauded investors to seek redress." 156 CONG. REC. H5237 (daily ed. June 30, 2010) (statement of Rep. Paul Kanjorski).

[15] Barbara Black & Jill Gross, Investor Protection Meets the Federal Arbitration Act, 1 Stan. J. Complex Litig. 1, Sept. 5, 2012, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2141978.

cc: Elisse B. Walter, Commissioner
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