FINANCIAL INDUSTRY REGULATORY AUTHORITY
NATIONAL ADJUDICATORY COUNCIL

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

DEPARTMENT OF ENFORCEMENT'S REPLY BRIEF

Thomas B. Lawson
Christopher A. Perrin
Daniel L. Gardner
FINRA Department of Enforcement
15200 Omega Drive
Rockville, Maryland 20850
301-258-8551 (Lawson voice)
202-721-8336 (Lawson fax)
thomas.lawson@finra.org

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INTRODUCTION

In its Opening Brief, the Department of Enforcement demonstrated that the Class Action Waiver adopted by Schwab violated NASD and FINRA rules. Enforcement also demonstrated that the Hearing Panel incorrectly failed to enforce the rule violations, erroneously finding that the Federal Arbitration Act ("FAA")[1] prevented FINRA from enforcing these rules.

Charles Schwab, & Co. argues in its Opening Brief that Rule 2268(d),[2] the rule at issue in this proceeding, is a federal regulation and that FINRA cannot enforce that regulation because it conflicts with the FAA. Schwab asserts that this disciplinary action is not based on the private membership agreement it entered into with FINRA but is instead an exercise of federal law-enforcement power by FINRA. This argument is no different than asserting that FINRA is a governmental actor, an argument that has been rejected by every court that has considered it, as well as repeatedly by the SEC and the NAC.

Moreover, there is no conflict between this disciplinary action and the FAA. This proceeding seeks to enforce the agreement Schwab made to abide by NASD and FINRA rules, including rules pertaining to predispute arbitration agreements ("PDAAs") and the arbitration process. The FAA does not invalidate other agreements entered into by a party—apart from an arbitration agreement—that modify that party's ability to take full advantage of its arbitration agreements. In raising the defense that the FAA allows its Class Action Waiver, Schwab is simply seeking to avoid compliance with the agreement it has made with FINRA.

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[1] 9 U.S.C. § 1, *et seq.*

[2] The Complaint alleges that Schwab violated NASD Rules 3110(f)(4)(A) and 3110(f)(4)(C) for the period prior to December 5, 2011 and FINRA Rules 2268(d)(1) and 2268(d)(3) for the period from December 5, 2011 to the present. NASD Rule 3110(f)(4)(A) is identical to FINRA Rule 2268(d)(1), and NASD Rule 3110(f)(4)(C) is identical to FINRA Rule 2268(d)(3). NASD Rule 3110(f)(4) was converted to FINRA Rule 2268(d) as part of the effort to create a consolidated rulebook for FINRA. No changes were made to the language of the rule as a part of that process. For ease of reference, we refer in this memorandum to the rule using its current numbering, FINRA Rules 2268(d)(1) and (3).

Schwab also argues that the Panel incorrectly found that Schwab violated Rule 2268(d)(3) because class action claims are not "claims." This argument is contrary to the clear meaning of the phrase "any claim" contained in Rule 2268(d)(3). Schwab further argues that, even if it did violate Rule 2268(d)(3), it did not receive adequate notice that the prohibitions of the rule covered its conduct. Given the broad and clear language used in Rule 2268(d)(3), this argument is without merit.

Schwab argues that the sanctions imposed by the Hearing Panel for the violations charged in the Third Cause of Action are excessive. Given the scope and magnitude of the violations, the sanctions imposed by the Hearing Panel are appropriate. Schwab placed the language at issue in account agreements for nearly seven million customers. The language is designed to prevent customers from consolidating claims in arbitration and directly contradicts Rule 12312 of the Code of Arbitration Procedure. Schwab acted intentionally in placing the language in its agreements. The $500,000 fine and requirement to provide corrective disclosure are appropriate sanctions under these circumstances.

Finally, Schwab argues that the NAC should remand the case to the Hearing Panel for an evidentiary hearing on sanctions if the NAC finds that Schwab's class action waiver violated Rule 2268(d). This is not necessary. All of the facts necessary to determine sanctions are established in the record.

The NAC should affirm the Hearing Panel's findings that Schwab violated NASD and FINRA rules, reverse the Hearing Panel's decision that the FAA prevents FINRA from enforcing those rules, affirm the sanctions imposed by the Hearing Panel for the Third Cause of Action, and impose appropriate sanctions for the violations alleged in the First and Second Causes of Action.

ARGUMENT

I. SCHWAB'S CLASS ACTION WAIVER VIOLATES NASD AND FINRA RULES.

A. Class Action Claims Are Included in the Phrase "Any Claim" in FINRA Rule 2268(d)(3).

The Hearing Panel found that Schwab violated FINRA Rule 2268(d)(3) by placing the Class Action Waiver in nearly seven million customer agreements.[3] Rule 2268(d)(3) prohibits firms from including in PDAAs "any condition that . . . limits the ability of a party to file any claim in court permitted to be filed in court" by FINRA's arbitration rules. As the Hearing Panel correctly found, Schwab's Class Action Waiver limits the ability of Schwab's customers to file class action claims against Schwab in court and therefore violates Rule 2268(d)(3).[4]

Schwab argues that the Panel erred in making this finding because class action claims are not included in the phrase "any claim" in Rule 2268(d)(3).[5] This argument is contradicted by the language of Rule 2268(d)(3) and by a common sense interpretation of the phrase "any claim."

1. The Plain Language of FINRA's Rules Demonstrates that Class Action Claims Are Encompassed by "Any Claim."

Class action claims are a particular type of claim. Under Rule 23 of the Federal Rules of Civil Procedure, class claims must meet a numerosity requirement, involve similar or identical questions of law and fact, and arise from a common set of operative facts.[6] Rule 23 requires, as one of the prerequisites of a class action, that "the *claims* or defenses of the representative parties are typical of the *claims or defenses of the class*"[7] and requires that notices to class members

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[3] R. 2465–66 (Hearing Panel Decision Granting in Part and Denying in Part the Parties' Cross-Motions for Summary Disposition (issued Feb. 21, 2013) ("Hearing Panel Decision") at 23–24).

[4] *Id.*

[5] Schwab Opening Brief at 36–37.

[6] *See* FED. R. CIV. P. 23(a) and (b).

[7] FED. R. CIV. P. 23(a)(3) (emphasis supplied).

state, among other things, "the class *claims*, issues, or defenses."[8]

The wording of Rule 2268(d)(3) is broad and unequivocal—it applies to "any claim." The obvious reading of that phrase is that it applies to any claim, including class action claims. This interpretation is supported by both the clear meaning of the phrase and by definitions and references in FINRA rules.

Rule 12204 of FINRA's Code of Arbitration Procedure addresses class actions. The rule is entitled "Class Action *Claims*" (emphasis supplied). The text of the rule refers specifically to "class action *claims*."[9] The rulemaking history to Rule 12204 also refers to "class action claims." In the SEC release approving Rule 12204, the SEC stated:

> [T]he NASD believes, and the Commission agrees, that the judicial system has already developed the procedures to manage *class action claims*. Entertaining such claims through arbitration at the NASD would be difficult, duplicative and wasteful.[10]

Thus, it is abundantly clear that FINRA Rule 12204 permits class action claims to be filed in court.[11] The reference in Rule 2268(d)(3) to "any claim in court permitted to be filed in court" under FINRA arbitration rules must obviously include class action claims.

The definition of "claim" contained in FINRA's Code of Arbitration Procedure also supports inclusion of class action claims. Rule 12100(d) of the Code defines a "claim" as "an allegation or request for relief." There is little doubt that class actions are comprised of both "allegations" and "requests for relief."

FINRA rules thus include class action claims within their broad use of the word "claims."

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[8] FED. R. CIV. P. 23(c)(2)(B) (emphasis supplied).

[9] *See* FINRA Rule 12204(a) (emphasis supplied).

[10] Order Approving Proposed Rule Change Relating to the Exclusion of Class Actions from Arbitration Proceedings, SEC Rel. No. 34-31371, 1992 SEC LEXIS 2767, *8 (Oct. 28, 1992) (emphasis supplied).

[11] The PDAA in Schwab's customer account agreement states the restrictions contained in Rule 12204(d), as required by Rule 2268(f). *See* R. 297 (CX-5, Schwab Account Agreement dated Jan. 2011, at 21.)

While Schwab argues that FINRA rules do not support this interpretation, it provides no real support for that argument. Instead, Schwab asserts simply that "waiving the ability to bring or participate in a class action does not waive any request for relief to which any customer might be entitled."[12] Whether that is true or not, it has nothing to do with whether a class action contains "a request for relief" or whether it contains "allegations."

2. Commonly Accepted Definitions of "Claim" Also Demonstrate that Class Action Claims Are Encompassed by "Any Claim."

Standard dictionary definitions of the word "claim" also support the inclusion of class action claims within the meaning of the word "claim." *Black's Law Dictionary* defines "claim" as follows:

> 1. The aggregate of operative facts giving rise to a right enforceable by a court <the plaintiff's short, plain statement about the crash established the claim>. Also termed claim for relief (1808). 2. The assertion of an existing right; any right to payment or to an equitable remedy, even if contingent or provisional <the spouses claim to half of the lottery winnings>. 3. A demand for money, property, or a legal remedy to which one asserts a right; esp., the part of a complaint in a civil action specifying what relief the plaintiff asks for.[13]

Class actions are included within all of the categories of this definition of "claim." They involve an "aggregate of operative facts giving rise to a right enforceable by a court," "[t]he assertion of an existing right; any right to payment or to an equitable remedy," "[a] demand for money, property, or a legal remedy to which one asserts a right; esp., the part of a complaint in a civil action specifying what relief the plaintiff asks for." This is demonstrated by the description of class actions contained in Rule 23 of the Federal Rules of Civil Procedure.[14]

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[12] Respondent Charles Schwab & Co. Inc.'s Opening Brief in Opposition to Department of Enforcement's Appeal and in Support of Schwab's Cross Appeal (filed May 22, 2013) ("Schwab Opening Brief") at 36.

[13] *Black's Law Dictionary* (9th ed.).

[14] Rule 23(a) states the prerequisites of class actions as follows: "One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is

(*continued to next page . . .*)

Schwab cites the *Black's Law Dictionary* definition of "claim" as support for its argument that class actions are not "claims."[15] However, Schwab's support for that conclusion is simply wordplay—"[p]laintiffs do not make a demand *for* a class action; rather, plaintiffs make their claim *as* a class action."[16]

The definition of "claim" in another common and widely used source, *Webster's Dictionary*, also makes clear that class actions are within the commonly understood meaning of the word "claim." *Webster's Dictionary* defines claim as "a demand for something due or believed to be due."[17] That definition clearly encompasses class action claims.

In the face of this evidence that class actions are "claims" under both FINRA rules and commonly used definitions, Schwab argues that, while class actions involve and assert claims, they are not themselves "claims."[18] This is a distinction without a difference for purposes of Rule 2268(d)(3). However class actions are described, including as procedural vehicles, they assert and involve claims in a way that includes them within the broad phrase "any claim" contained in Rule 2268(d)(3).

In fact, given the breadth of the phrase in Rule 2268(d)(3)—"any claim"—and the

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(. . . *continued from prior page*)
impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class." FED. R. CIV. P. 23(a). Moreover, federal courts routinely use the phrases "class claim" and "class-action claim" in discussing claims asserted by a class or a putative class under Rule 23. *See, e.g., Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011) (J. Scalia for the majority and J. Ginsburg in dissent both used the term "class claim"); *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71 (2006) (concluding that "SLUSA pre-empts state-law holder class-action claims of the kind alleged in [the complaint]"); *Safeco Ins. Co. of Am. v. Am. Int'l Group, Inc.*, 710 F.3d 754 (7th Cir. 2013) (J. Easterbrook for the majority and J. Posner in dissent both used the term "class claim"); *McCrary v. Stifel, Nicolaus & Co.*, 687 F.3d 1052 (8th Cir. 2012) (referring to "class-action claims" and "class claims"). Indeed, within the last 10 years, the phrases "class claim" or "class action claim" have appeared in thousands of federal court decisions.

[15] *See* Schwab Opening Brief at 37.

[16] *Id.* (emphasis in original).

[17] Available at http://www.merriam-webster.com/dictionary/claim.

[18] *See* Schwab Opening Brief at 37–38.

definitions in FINRA rules and commonly used sources, the burden is on Schwab to identify something in the rule's language or rulemaking history that would provide a basis to conclude that class action claims are not included in the phrase "any claim." Schwab has failed to do that. Schwab also does not suggest that any regulator or court has ever interpreted the phrase "any claim" to exclude class action claims or that the phrase was ever intended to have a narrower meaning than its plain meaning would indicate—*i.e.*, *any* claim.

3. Schwab's Argument that "Any Claim" Refers Only to Claims that Are Barred Under FINRA Rule 12206 Is Wrong.

Schwab argues that the phrase "any claim" actually refers to claims that are ineligible for FINRA arbitration because they are barred by the six-year limit set out in Rule 12206(a) of the Code of Arbitration Procedure. In support of this argument, Schwab notes that issues concerning the eligibility rule were discussed in the rulemaking history to Rule 2268(d)(3).[19]

However, Schwab ignores the absence of any language in either the rule or its rulemaking history suggesting that the phrase "any claim" is *limited* in this manner. In fact, the rulemaking history makes it clear that the coverage of the rule was not limited to issues concerning the six-year eligibility rule, and instead that that was simply one concern. In the SEC release proposing adoption of what became Rule 2268(d)(3), the SEC stated that "paragraph (f)(4) of the Rule would be amended to clarify *the prohibition against provisions that limit rights or remedies, including* provisions that would circumvent [the eligibility rule]."[20] The rulemaking history makes clear that the purpose of the rule was to adopt a broad

[19] Schwab Opening Brief at 39–41.

[20] *See* Order Granting Approval to Proposed Rule Change as Amended and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 5 by the National Association of Securities Dealers, Inc., Regarding NASD Rule 3110(f) Governing Predispute Arbitration Agreements with Customers, SEC Rel. No. 34-50713, 2004 SEC LEXIS 2832, *4 (Nov. 22, 2004) (emphasis supplied).

prohibition "against provisions that limit rights or remedies."[21] It was not limited to any specific activity.[22]

B. Schwab's Class Action Waiver Contradicts FINRA Rule 12204.

The Hearing Panel found that Schwab violated Rule 2268(d)(1), as charged in the Second Cause of Action, because its Class Action Waiver contradicts the provisions of FINRA Rule 12204(d).[23] This finding should be affirmed.

Rule 2268(d)(1) prohibits inclusion in a pre-dispute arbitration agreement of "any condition" that "limits or contradicts the rules of any self-regulatory organization." Because Rule 12204(a) prohibits class claims from being filed in arbitration, Rule 12204(d) contains a number of provisions that are intended to preserve investor access to the courts for class actions. Rule 12204(d) accomplishes this by prohibiting firms from enforcing arbitration agreements against members of putative or certified class actions until class certification is denied, the class is decertified, the member of the class is excluded by the court, or the member elects not to participate or withdraws under conditions set by the court.

Schwab's Class Action Waiver contradicts Rule 12204(d) by prohibiting Schwab's customers from filing or participating in any class or representative actions against Schwab in court. As the Hearing Panel correctly found, Schwab's Class Action waiver "deprive[s] the customer of the ability to bring or participate in a judicial class action, as permitted by FINRA

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[21] *Id.*

[22] *See also* NASD Notice to Members 05-09 at 3 (Jan. 2005) (referring to Rule 2268(d)(3) as one of the "restrictions on provisions that limit rights or remedies").

[23] Schwab makes no argument in its Opening Brief regarding the meaning or application of Rule 2268(d)(1). By failing to make any such argument, Schwab concedes that the Second Cause of Action turns exclusively on FINRA Rule 12204(d). Thus, if Schwab's Class Action Waiver contradicts Rule 12204(d), then the Hearing Panel's decision that Schwab violated Rule 2268(d)(1) as alleged in the Second Cause of Action must be affirmed.

Rule 12204, in violation of . . . subsection (d)(1) . . . of FINRA Rule 2268."[24] Both the language of the rules and applicable rulemaking history make this clear.

1. The Language of Rule 12204(d) Preserves Court Access for Class Actions.

Schwab argues that the Hearing Panel did not "examine[]" the text of Rule 12204.[25] To the contrary, as the Hearing Panel stated, its analysis was based on "[a] common sense reading of FINRA Rule 12204 in conjunction with FINRA Rules 2268(d)(1) and (d)(3)."[26] Indeed, the Hearing Panel decision devoted several pages of analysis to the text and structure of the Rules, including Rule 12204.[27] The Panel's analysis led it to the unavoidable conclusion that Rule 12204(d) operates "to preserve the option for customer claims to be resolved in court in a class action"[28] and that "Schwab's Waiver would bar customers from bringing or participating in judicial class actions" in violation of Rules 2268(d)(1) and (d)(3).[29]

Schwab also argues that "[t]he express language [of Rule 12204] prohibits a member from *enforcing* an arbitration agreement and compelling use of FINRA Dispute Resolution against a member of a certified or putative class *unless* the court disposes of the class action allegations[.]"[30] This is a misstatement of the rule's prohibition. Rule 12204 does not prohibit a member from enforcing an arbitration agreement *unless* the court disposes of the class action allegations; it prohibits members from enforcing an arbitration agreement *until* the court disposes

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[24] R. 2465 (Hearing Panel Decision at 23).

[25] *See* Schwab Opening Brief at 28.

[26] R. 2466 (Hearing Panel Decision at 24).

[27] *See e.g.*, R. 2455–59 (THE FINRA AND NASD RULES AT ISSUE, Hearing Panel Decision at 13-17); *see also* R. 2465–74 (Hearing Panel Decision at 23–32).

[28] R. 2467 (Hearing Panel Decision at 25).

[29] R. 2468 (Hearing Panel Decision at 26).

[30] Schwab Opening Brief at 29 (emphasis in original).

of the class action allegations or the customer opts out of the putative or certified class.[31]

This conclusion is supported by the court's analysis in *Good v. Ameriprise Financial Inc.*[32] The *Good* court closely examined the text of Rule 12204(d) and noted the significance of the use of the definite article "the" (i.e., "the class" and "the member") in the first three bulleted exceptions of the rule. The court stated that the exceptions:

> describe conditions that, by definition, cannot occur until after a class action has been initiated: the denial of class certification, the decertification of a class, and the exclusion of a person from a class. None of these can occur until a putative class action has been filed and assigned to a judge. The [fourth] exception is cut from the same cloth. It refers to an election not to participate in "the putative or certified class action," which again refers not to any class action, but to the same class action to which the [first three] exceptions refer—the particular class action that "has [been] initiated." In other words, the [fourth] exception applies only to an election not to participate in a particular putative or certified class action, and only if the election is made after that putative or certified class action is initiated.[33]

Schwab also suggests that the statement at the end of Rule 12204(d) that "[t]his paragraph does not otherwise affect the enforceability of any rights under this Code or any other agreement" means that it can use its Class Action Waiver to force customers out of class actions before class certification issues are decided, because its Class Action Waiver is such an "other

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[31] The disclaimer language required by Rule 2268(f), which was promulgated in 2004 and which Schwab includes in its customer agreements, states:

> No person shall . . . seek to enforce any pre-dispute arbitration agreement against any person who has initiated in court a putative class action; or who is a member of a putative class who has not opted out of the class with respect to any claims encompassed by the putative class action until: (i) the class certification is denied; or (ii) the class is decertified; or (iii) the customer is excluded from the class by the court.

FINRA Rule 2268(f). *See also* R. 297 (CX-5, Schwab Account Agreement, at 21). Thus, Rule 2268(f) makes clear that Schwab cannot use the its PDAA (containing the Class Action Waiver) to force a customer out of a class because doing so would be "seek[ing] to enforce any pre-dispute arbitration agreement" before class certification issues have been decided.

[32] *See Good v. Ameriprise Financial Inc.*, 2007 Dist. LEXIS 9298, at *6–7 (D. Minn. Feb. 8, 2007) (the *Good* court analyzed a prior version of the rule but the analysis applies equally to the current language).

[33] *Id.*

agreement."[34] The provisions of Rule 12204(d) apply to "any arbitration agreement" and thus the reference to "any other agreement" means an agreement other than the arbitration agreement. However, Schwab's Class Action Waiver is part of its PDAA[35] and, therefore, cannot be an "other agreement" as referred to in the last sentence of Rule 12204(d). It would make no sense for Rule 12204(d) to prohibit the use of a PDAA to prevent investors from pursuing class action claims until a court has decided certification issues, only to allow part of the same agreement to be used for that exact purpose.

2. The Rulemaking History of Rule 12204(d) Shows that It Was Intended to Preserve Court Access for Class Actions.

Schwab also argues that the Hearing Panel incorrectly interpreted the rulemaking history to Rule 12204(d). In fact, the rulemaking history shows that Rule 12204(d) was adopted in part to prevent exactly the action that Schwab claims it plans to take. The SEC noted in its order approving the rule that:

> 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. *In the past, individuals who attempted to certify class actions in litigation were subject to the enforcement of their separate arbitration contracts by their broker-dealers*. Without access to class actions in appropriate cases, both investors and broker-dealers have been put to the expense of wasteful, duplicative litigation. *The new rule ends this practice.*[36]

The purpose of Rule 12204(d) to ensure investor access to the courts for class action claims is made very clear in the rule's history. The predecessor to Rule 12204(d)— Code of

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[34] *See* Schwab Opening Brief at 29.

[35] *See* R. 251 (Department of Enforcement's Statement of Undisputed Facts, attached as Exhibit A to Department's Motion for Summary Disposition, at ¶ 14).

[36] Order Approving Proposed Rule Change Relating to the Exclusion of Class Actions from Arbitration Proceedings, SEC Rel. No. 34-31371, 1992 SEC LEXIS 2767, *9 (Oct. 28, 1992) (emphasis supplied).

Arbitration Procedure Section 12(d)(3)— was proposed in July 1992.[37] In proposing Section 12(d)(3), NASD stated that it was:

> developed from a suggestion made to all self-regulatory organizations (SROs) in a letter dated July 13, 1988, from the Chairman of the Securities and Exchange Commission, David S. Ruder. Chairman Ruder asked the SROs to consider adopting procedures that would give investors access to the courts in appropriate cases, including class actions.[38]

In October 1992, the SEC approved the predecessor to Rule 12204(d). The SEC made clear at that time that it agreed that the intent of the rule was to provide investor access to judicial class action claims.[39] In the approval order, the SEC stated:

> 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. . . . *The Commission believes that investor access to the courts should be preserved for class actions* and that the rule change approved herein [the adoption of Rule 12204] provides a sound procedure for the management of class actions arising out of securities industry disputes between NASD members and their customers.[40]

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[37] The original predecessor to Rule 12204(d) was § 12(d)(3) of the Code of Arbitration Procedure. *See* Proposed Rule Change by National Association of Securities Dealers, Inc., Relating to Improvements in the NASD Code of Arbitration Procedure, SEC Rel. No. 34-30882, 1992 SEC LEXIS 1566 (July 1, 1992). In 1996, Section 12(d) of the Code of Arbitration Procedures was renumbered Rule 10301(d). In 2007, Rule 10301 was renumbered as Rule 12204. In 2008, NASD Rule 12204 became FINRA Rule 12204.

[38] Proposed Rule Change, 1992 SEC LEXIS 1566 at *5–6.

[39] *See* Order Approving Proposed Rule Change, 1992 SEC LEXIS 2767.

[40] *Id.* at *9–10 (emphasis supplied) . The purpose underlying Rule 12204(d) was further confirmed when the predecessor to Rule 12204 was amended in 1994. *See* Notice of Filing Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Exclusion of Class Action Claims from Arbitration, SEC Rel. No. 34-33506, 1994 SEC LEXIS 197, *3 (Jan. 24, 1994). The 1994 amendment was proposed to clarify that the prohibition on class actions in arbitration applied to member firms and associated persons as well as customers. *See id.* Moreover, In approving the amendment, the SEC stated:

> Over the years of the evolution of class action litigation, the courts have developed the procedures and expertise for managing class actions. ... The Commission also believes that access to the courts for class action litigation should be preserved for associated persons and member firms as well as for investors and that the rule change approved herein provides a sound procedure for the management of class actions.

Order Approving Proposed Rule Change Relating to Exclusion of Class Action Claims from Arbitration, SEC Rel. No. 34-33939, 1994 SEC LEXIS 1156, *3–4 (April 20, 1994).

3. *Schwab Violated FINRA's Rules by Including the Class Action Waiver in Its PDAA; It Is Irrelevant that Schwab Has Not Yet Enforced It Against a Customer.*

Despite these clear and unambiguous statements regarding the purpose of the rule, Schwab asserts that it's Class Action Waiver, which is designed to *prevent* customers from *filing or participating in any manner* in a class action in court against Schwab, is consistent with Rule 12204(d).[41] First, this is directly contradicted by the language of the rule and by the rulemaking history described above. Second, Schwab's argument is, in effect, that its Class Action Waiver does not violate Rule 2268(d) because the firm has not enforced the waiver in court, as prohibited by Rule 12204(d). Schwab ignores the language of Rule 2268(d) in making this argument. Rule 2268(d) prohibits the *inclusion* in a PDAA of language that contradicts the rule of an SRO. The violation is committed when language is included in the agreement. No further action is necessary. To violate Rule 2268(d), it is not necessary to attempt to enforce an arbitration agreement, only to include language in a PDAA that limits or contradicts an SRO rule. The inclusion of that language, in and of itself, does harm by suggesting to the customer that he or she has given up whatever protection the SRO rules provide.

4. *The Rule 13204 Cases Cited by Schwab Are Inapposite.*

Schwab also cites two cases involving employee class action waivers that analyze Rule 13204 of the Code of Arbitration for Industry Disputes.[42] Those cases do not control the result in this case. Different considerations apply to Rule 12204, which applies to customer class action waivers, than apply to Rule 13204, which concerns employee class action waivers. Most

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[41] *See* Schwab Opening Brief at 28–31.

[42] Those cases are *Cohen v. UBS Financial Services, Inc.*, 2012 U.S. Dist. LEXIS 174700 (S.D.N.Y. Dec. 3, 2012) and *Suschil v. Ameriprise Financial Services Inc.*, 2008 U.S. Dist. LEXIS 27903 (N.D. Ohio Apr. 7, 2008). Schwab also cites *French v. First Union Securities*, 209 F.Supp. 2d 818 (M.D. Tenn. 2002), a case involving customer class action claims, but the case is not helpful to Schwab. The case analyzes "whether a party having both class action and non-class action claims may compel arbitration of the non-class action claims" and holds that "[o]nce a class-action claim is dismissed, it is no longer a roadblock to the arbitration of non-class claims." *Id.* at 833.

importantly, while Rule 2268(d) prescribes the content of PDAAs with customers, there is no such rule regulating the content of PDAAs with employees. There is no rule prohibiting PDAAs with employees that contain provisions that contradict SRO rules or which limit the ability of employees to file claims in court. Thus, the very rule at issue in this case—Rule 2268(d)—does not apply to employee class action waivers.[43] As the Hearing Panel noted:

> Regardless of whether [the conclusion of the court in *Cohen*] 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.[44]

C. Schwab's Notice Arguments Are Without Basis.

Schwab argues that it did not have appropriate notice that its Class Action Waiver violated Rule 2268. This argument is without basis.

The Hearing Panel dismissed this argument by noting that Schwab has claimed in this proceeding that it waited until after the Supreme Court's decision in *AT&T Mobility v. Concepcion*[45] to adopt the Class Action Waiver, thus evidencing its understanding that class action waivers were previously prohibited: "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."[46]

Whatever the reason for Schwab's decision to adopt the Class Action Waiver, Rule 2268(d) provided abundant notice that it prohibited the Class Action Waiver. The charge in the

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[43] *Suschil* also involved collective actions rather than class actions and the court distinguished collective actions from class actions in its analysis. 2008 U.S. Dist. LEXIS 27903 at *14–15.

[44] R. 2468 (Hearing Panel Decision at 26 n.58). Moreover, as the Hearing Panel noted, there is no unanimity in the court cases involving industry disputes under FINRA Rule 13204. *Id.*

[45] 131 S. Ct. 1740 (2011).

[46] R. 2468 (Hearing Panel Decision at 26). The Hearing Panel made this finding based on arguments made by Schwab's counsel during the proceeding below, as shown by its citation to oral argument and Schwab's briefing as support for the finding. *See* R. 2465 (Hearing Panel Decision at 23 n.52).

First Cause of Action is based on the reading of the phrase "any claim" to mean *any* claim, including class action claims.[47] The rule prohibits firms from placing language in PDAAs limiting the ability of customers to file any claim in court permitted to be filed in court by FINRA arbitration rules. This language clearly includes class action claims, as discussed in detail above. Thus, the rule provides clear notice that it prohibits class action waivers. This is not a case where a "new" or "retroactive" interpretation of a rule has been adopted, as Schwab suggests. The purpose of Rule 12204(d) to ensure investor access to court for class actions is evident on the face of the rule and clear from the rule's history, as discussed in detail above.[48]

The well-established legal standards in this area support the conclusion that Rules 2268(d) and 12204(d) provide more than adequate notice to support this enforcement action.[49] It is well established that the plain meaning of a rule governs its interpretation.[50] It is not

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[47] *See, e.g., Ali v. Federal Bureau of Prisons*, 552 U.S. 214, 222 (2008) (rejecting Federal Tort Claim Act complaint by prisoner claiming damages for lost property during prison transfer). In interpreting the provisions and exceptions to the Federal Tort Claim Act's waiver of sovereign immunity, the Supreme Court rejected the prisoner's argument of a narrow exception to the waiver. The Court stated that "Congress could not have chosen a more all-encompassing phrase than 'any other law enforcement officer' to express that intent. We have no reason to demand that Congress write less economically and more repetitiously." *Id.* at 221. Similarly, it would hardly have been possible for FINRA to have been more specific or succinct in prohibiting limitations on actions in court than by using the words "any condition" and "any claim" in Rule 2268(d)(3).

[48] In addition, in NASD Notice to Members 92-65 (Dec. 1992), NASD made clear the purpose of Rule 12204(d). As the Hearing Panel noted, NASD stated:

> [N]o 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." This language indicates that NASD believed that customers retained the right to pursue claims in 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.

R. 2467–68 (Hearing Panel Decision at 25–26).

[49] And as noted above, Schwab does not argue that it had inadequate notice that Rule 2268(d)(1) prohibits arbitration agreements from limiting or contradicting FINRA rules (like Rule 12204(d)). *See* footnote 22, *supra.*

[50] *DOE v. Bullock*, Complaint No. 2004003437102, 2011 FINRA Discip. LEXIS 14, *19 (NAC May 6, 2011) (citing *K Mart Corp. v. Cartier, Inc.*, 486 U.S. 281, 291–92 (1988) (statutory analysis must begin with the plain language of the rule); *see also Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 6 (2000)

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necessary for a rule to specify each possible type of instance where it might be violated, particularly where the rule contains a broad and simple prohibition.[51]

For instance, in *SEC v. Gemstar-TC Guide International, Inc.*,[52] the court rejected the defendant's vagueness challenge to the phrase "extraordinary payments" in Section 1103 of the Sarbanes-Oxley Act of 2002. The SEC sought to have defendant's funds placed in escrow under that provision. After reviewing the standards for vagueness challenges to regulatory rules, the court held:

> We conclude that the district court was correct in its understanding of the meaning of 'extraordinary payments' and in the application of that flexible standard to the facts and circumstances of this case. Wisely, we believe, both Congress and the SEC have avoided creating a specific litmus test that determines what is or is not an 'extraordinary payment.' To do so for all possible situations would be next to impossible and would serve only to guide corporate scoundrels searching for ways to circumvent this salutary law.[53]

The NAC's holding in *DOE v. Jordan*[54] is also instructive. In that case, the respondent was charged with violating NASD Rule 2711 by failing, among other things, to disclose conflicts of interest which arose from employment discussions she had with the subject company of her

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("When the statute's language is plain, the [adjudicator's] sole function . . . is to enforce it according to its terms"); *United States v. Ron Pair Enter., Inc.*, 489 U.S. 235, 241 (1989) (same).

[51] *See, e.g., American Funds Distributors, Inc.*, Exchange Act Rel. No. 64747, 2011 SEC LEXIS 2191, *19 n.23 (June 24, 2011) (in reaching the result in that case the SEC stated it did "not intend to suggest that regulatory requirements are enforceable only to the extent the language used precisely delineates each course of conduct that is covered"); *SIG Specialists, Inc.*, Exchange Act Rel. No. 51867, 2005 SEC LEXIS 1428, **20–21 (June 17, 2005) (rejecting argument that rule requiring firm to "maintain a fair and orderly market" could not be enforced where specific steps were not delineated in the rule). In rejecting the firm's argument in *SIG Specialists*, the SEC stated: "We also note that the court in *General Bond* cautioned that its "ruling should not be taken to mean that every disciplinary action taken by the NASD or SEC will be considered a 'rule change' unless an interpretation has been previously submitted to the SEC showing that identical conduct has been held to violate an NASD rule." 2005 SEC LEXIS 1428, **20–21 (citing *General Bond & Share Co. v. SEC*, 39 F.3d 1451 (10th Cir. 1994)).

[52] 401 F.3d 1031 (9th Cir. 2005).

[53] *Id.* at 1048. *See also V.H. Costello Securities, Inc.*, Exchange Act Rel. No. 29560, 1991 SEC LEXIS 1589, *15 (Aug. 15, 1991) ("In delegating regulatory responsibilities to the NASD, Congress has used such language and, under the statutory scheme, the NASD has discharged its duties both to protect the public and to give sufficient guidance to member firms and NASD officials.").

[54] Complaint No. 2005001919501, 2009 FINRA Discip. LEXIS 15 (NAC Aug. 21, 2009).

research reports. Rule 2711 does not specifically refer to employment discussions but requires the disclosure of conflicts of interest.[55] The NAC rejected the respondent's argument that an enforcement proceeding for failing to disclose employment discussions "constituted an unenforceable 'rule change'" because "[t]he rules provided more than a reasonable opportunity for [the respondent] Jordan to know that her conduct was prohibited." The NAC found that the failure to disclose the employment discussions was reasonably and fairly implied by the *general* requirement of the rule to disclose conflicts of interest.[56]

Rule 2268(d)(3) sets out a broad and simple prohibition. FINRA must be afforded the regulatory flexibility to address violations of that prohibition on a case-by-case basis.

The cases cited by Schwab do not require a different result. None of Schwab's cases involve issues of rule interpretation that are applicable in this case.[57] Schwab also cites no

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[55] NASD Rule 2711(h)(1)(C) requires disclosure of "any other actual, material conflict of interest of the research analyst or member of which the research analyst knows or has reason to know at the time of publication of the research report or at the time of the public appearance."

[56] *Jordan*, 2009 FINRA Discip. LEXIS 15 at *33 n.14.

[57] Each of the cases cited by Schwab involves significantly different issues of rule interpretation and provide little guidance in this case. In *Upton v. SEC*, 75 F.3d 92 (2d Cir. 1996), the conduct at issue complied with the literal terms of the rule at issue and the court found the SEC was "aware that brokerage firms were evading the substance of" the rule at issue "two years before the events in this case took place." *Id.* at 98. *Upton* involved a much more complicated rule, Rule 15c3-3(e) under the Exchange Act, which requires broker-dealers to maintain a separate bank account with customer funds based on a complicated weekly calculation. The question in the case was whether a practice of paying down certain loans just before the weekly computation and reinstating those loans the next business day was permissible under the complex terms of that rule. *KPMG, LLP v. SEC*, 289 F.3d 109 (D.C. Cir. 2002), involved an alleged violation of AICPA Rule 302 by KPMG when it obtained a royalty fee from a non-client (who had a licensing agreement with KPMG) where the language of rule concerned receipt of a contingent fees from clients. *General Bond*, 39 F.3d 1451, involved a holding that NASD could not rely upon on the general just and equitable principles rule to prohibit the specific practice of market makers receiving compensation from issuers for making a market in their securities. *Bloomberg, L.P.*, Exchange Act Rel. No. 49076, 2004 SEC LEXIS 79 *13 (Jan. 14, 2004), involved a holding by the SEC that the NYSE's restrictions concerning access to market data was not reasonably and fairly implied by the Exchange rule at issue because it "prescribe[d] extensive and specific limitations on particular types of transactions or conduct that are not apparent from the face of the existing rule."

Similarly, *William J. Higgins*, Exchange Act Rel. No. 24429, 1987 SEC LEXIS 1879, *3 (May 6, 1987) involved whether the NYSE could prohibit its members from installing telephones to communicate with non-members located off the floor under a rule stating that only members are allowed to transact business on the floor and a rule governing telephone links between members and the floor (as opposed to non-members). *Interactive Brokers*, Exchange Act Rel. 39765, 1998 SEC LEXIS 449, *2–3 (March 17, 1998) involved a restriction of the use of hand-held routing terminals based on a policy that had not been submitted or approved as a rule. *American Funds*

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authority suggesting that rules that contain broad and clear prohibitions are enforceable only to the extent they precisely describe delineates the conduct at issue. In this case, the meaning of the rules is clear and their application to Schwab's Class Action Waiver is obvious.

II. THE FAA DOES NOT PROHIBIT FINRA FROM ENFORCING ITS RULES IN THIS PROCEEDING.

The Hearing Panel found that Schwab's Class Action Waiver violated Rules 2268(d)(1) and 2268(d)(3) but refused to impose sanctions for these violations because it concluded that the FAA prevents FINRA from enforcing the rules. As demonstrated in Enforcement's Opening Brief, this conclusion is incorrect. The FAA does not prevent FINRA from enforcing its rules in this case.

A. This Proceeding Seeks To Enforce Schwab's Membership Agreement and Is Not Prohibited by the FAA.

Schwab agreed, in its membership agreement, to abide by and adhere to NASD and FINRA rules.[58] This means, quite simply, that while Schwab might adopt a Class Action Waiver in the absence of its agreement with FINRA, it cannot do so as a FINRA member, because NASD and FINRA rules prohibit that conduct.

As demonstrated by Enforcement in its Opening Brief, Supreme Court cases make it clear it is consistent with the FAA to recognize the validity of other agreements—apart from an arbitration agreement—that modify a party's ability to take full advantage of its arbitration agreement. Indeed, enforcing the membership agreement in this case is consistent with the

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Distributors, 2011 SEC LEXIS 2191 at **18-19, involved a holding by the SEC setting aside an NASD interpretation that the phrase "conditioned upon" should be construed broadly to prohibit using mutual fund sales as a "prerequisite" to directing brokerage commissions to broker-dealers selling fund shares.

[58] *See* R. 250 (Department of Enforcement's Statement of Undisputed Facts, ¶ 4); R. 257–262 (Exhibit CX-1, Schwab's most recent amended membership application). Schwab has recertified its agreement to abide by those rules numerous times.

FAA, a statute whose purpose is to ensure that private agreements are enforced.[59]

Schwab argues that its membership in FINRA is not voluntary[60] and that it therefore does not need to abide by its membership agreement. There is no factual or legal support for this argument. First, as a factual matter, Schwab's decision to be a FINRA member is entirely voluntary. Nothing forces Schwab into FINRA membership. Nothing in the Exchange Act designates FINRA by name or function as the Act's sole national securities association, and nothing forces Schwab into conducting a securities business in the United States. Second, as a legal matter, FINRA's position as the only entity currently registered as a national securities association does not make it a state actor or governmental entity.[61] Thus Schwab's argument is both factually and legally wrong.

In addition to lacking factual and legal support, Schwab's argument, if accepted, would have severe consequences for the future of self-regulation. Any firm could argue as Schwab has that it has no obligation to abide by FINRA rules since it considers its membership in FINRA to be involuntary. The NAC should obviously reject this argument.

Schwab receives the benefits of its membership agreement with FINRA but must, in turn, comply with the terms of that agreement. Schwab's agreement to abide by NASD and FINRA

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[59] See Enforcement's Opening Brief at 21–25.

[60] *See* Schwab Opening Brief at 16 n.6.

[61] Since the 2007 merger of the NYSE and NASD, numerous court and SEC cases have held FINRA is not a state actor. *See e.g.*, *Epstein v. SEC*, 416 Fed. Appx. 142, 148 (3d Cir. 2010) ("[T]he NASD is a private actor, not a state actor"); *Flowers v. Wells Fargo Advisors, LLC*, 2013 U.S. Dist. LEXIS 21323 (E.D.N.C. Jan. 30, 2013) (holding NASD is not a state actor); *Lanzisera v. Hoffman*, 2001 U.S. Dist. LEXIS 20646, *7 (S.D.N.Y. Dec. 11, 2001) ("It is quite clear that neither the NASD nor the two individual Defendants are 'state' actors."); *Epstein v. FINRA*, 2009 U.S. Dist. LEXIS 29828, *4–5 (D.N.J. Apr. 9, 2009) ("FINRA, formerly known as NASD, and its employees . . . are not state actors."); *Timothy H. Emerson*, Exchange Act Rel. No. 60328, 2009 SEC LEXIS 2417 (July 17, 2009); *Scott Epstein*, Exchange Act Rel. No. 59328, 2009 SEC LEXIS 217 (Jan. 30, 2009); *Mission Securities Corp.*, Exchange Act Rel. No. 63453, 2010 SEC LEXIS 4053, *31 n.21 (Dec. 7, 2010); *Kevin M. Glodek*, Exchange Act Rel. No. 60937, 2009 SEC LEXIS 3936 (Nov. 4, 2009); *Asensio & Company, Inc.*, Exchange Act Rel. No. 68505, 2012 SEC LEXIS 3954, *61 (Dec. 20, 2012); *Gregory Evan Goldstein*, Exchange Act Rel. No. 68904, 2013 SEC LEXIS 552, *20 (Feb. 11, 2013); *Richard A. Neaton*, Exchange Act Rel. No. 65598, 2011 SEC LEXIS 3719, *34 (Oct. 20, 2011); *Eric J. Weiss*, Exchange Act Rel. No. 69177, 2013 SEC LEXIS 837, *21 n.40 (March 19, 2013).

rules includes rules relating to the arbitration process and PDAAs. Nothing in the FAA limits the ability of a party to waive or otherwise limit rights that it otherwise might have had under the statute, so the FAA does not provide an exception to the agreement Schwab made to abide by NASD and FINRA rules. Schwab also agreed to be subject to sanctions for rule violations. That is what this disciplinary action seeks.

B. The Rules at Issue Are Not Hostile to Arbitration.

The Hearing Panel found that Rules 2268(d)(1) and 2268(d)(3) and Rule 12204(d) represent a "hostility to arbitration" that bars their enforcement under the FAA.[62] That is incorrect.

The Code of Arbitration Procedure is not hostile to arbitration, but instead provides the structure for one of the world's largest arbitration forums.[63] The specific exclusion of class action claims from arbitration, and the corresponding provisions of Rule 12204(d) allowing those claims to be brought in court until a court decides certification issues, are the result of reasoned decisions by FINRA and the SEC.[64] FINRA determined, and the SEC agreed, that class action claims are not well-suited to arbitration and that courts have well-established and efficient mechanisms for handling those claims. These rules do not express hostility to arbitration.

Rule 2268(d)(3) prohibits the inclusion in a predispute arbitration agreement of "any condition that . . . limits the ability of a party to file any claim in court *permitted to be filed in court under the rules of the forums in which a claim may be filed under the agreement*" (emphasis supplied). The highlighted language makes it clear that the rule limits the ability to

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[62] R. 2451 (Hearing Panel Decision at 9).

[63] *See STMicroelectronics, N.V. v. Credit Suisse Sec. (USA) LLC*, 648 F.3d 68, 72 (2d Cir. 2011) (explaining that FINRA "operates 'the largest securities dispute resolution forum in the world'") (quotation not cited); *see also* www.finra.org/AboutFINRA (last visited June 14, 2013).

[64] *See* discussion above at Section I.B.2.

file *only* those claims that the rules of the *selected arbitration forum allow* to be filed in court. This illustrates without doubt that Rule 2268(d)(3) is not hostile to arbitration. In fact, the rule is specifically tailored to be consistent with the rules of the arbitration forum at issue.

It is also worth noting that, in adopting its Class Action Waiver, Schwab is not seeking to arbitrate anything. Even before amending its customer agreement to include the Class Action Waiver, Schwab had a PDAA in its agreement with customers.[65] The Class Action Waiver relates only to how Schwab will address class action claims, since those cannot be filed in FINRA arbitration. Schwab does not seek through its Class Action Waiver to arbitrate those claims. Rather, it seeks to preclude them entirely.

C. FINRA Is Not a State Actor, and Its Rules Are Not Federal Laws or Regulations.

Schwab argues in its Opening Brief that FINRA rules are federal law and as such cannot conflict with the FAA:

> Because FINRA has accepted a delegation of federal power under the Exchange Act and exercised such power to promulgate the rules at issue here, Schwab's membership agreement does not allow Enforcement to act beyond the scope of FINRA's delegation of federal power. The days of purely private self-regulation are long gone as a result of the SEC-approved merger of the regulatory functions of NYSE and NASD and FINRA's subsequent acceptance and exercise of federal rulemaking and regulatory authority.[66]

FINRA is not a state actor and does not exercise federal law enforcement powers. FINRA rules are not federal regulations. Schwab's argument that FINRA is a governmental actor has been repeatedly and consistently rejected by the NAC, the SEC, and the courts. In fact, in the 75 years since the Maloney Act was passed, every court that has considered the issue has

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[65] *See* R. 251 (Department of Enforcements Statement of Undisputed Facts at ¶ 14); R. 275–362 (CX-5, Schwab Customer Agreement dated Jan. 2011).

[66] Schwab Opening Brief at 11. Schwab later argues that "[w]henever Enforcement takes disciplinary action against a member for violating FINRA's rules, it is the equivalent of enforcing federal regulations." *Id.* at 17.

held that FINRA, and NASD before it, is not a state actor.[67]

FINRA is a private, not-for-profit corporation, registered with the SEC as a national

[67] *See e.g., Graman v. NASD*, 1998 U.S. Dist. LEXIS 11624 at *9 ("Every court that has considered the question has concluded that NASD is not a governmental actor."); *United States v. Bloom*, 450 F. Supp. 323, 330 (E.D. Pa. 1978) (concluding "that the NASD is not part of the government and its actions cannot be imputed to it nor its agents to bind it. To hold otherwise would be to eliminate a bulwark of our economic regulatory scheme, for there would be no need for a NASD if it were in effect a lower level of the SEC. Although private, it plays an important role in the scheme of securities regulation. It allows the securities industry to keep its own house clean and holds back the seemingly overwhelming tide of government supervision. Therefore, the Court will not consider the acts of NASD officials or their comments to be imputed to the SEC."); *Desiderio*, 191 F.3d at 206 ("[T]he NASD is a private actor, not a state actor. It is a private corporation that receives no federal or state funding. Its creation was not mandated by statute, nor does the government appoint its members or serve on any NASD board or committee. Moreover, the fact that a business entity is subject to 'extensive and detailed' state regulation does not convert that organization's actions into those of the state."); *First Jersey Secs., Inc. v. Bergen*, 605 F.2d 690, 698, (3d Cir. 1979) ("NASD is a voluntary association, not a state agency"); *Shrader v. NASD, Inc.*, 855 F. Supp. 122, 124 (E.D.N.C. 1994) (holding NASD is not a state actor), *aff'd*, 54 F.3d 774 (4th Cir. 1995); *Cremin v. Merrill Lynch Pierce Fenner & Smith, Inc.*, 957 F. Supp. 1460, 1468 (N.D. Ill. 1997); *Datek Secs. Corp. v. NASD, Inc.*, 875 F. Supp. 230, 234 (S.D.N.Y. 1995) ("NASD is a private, rather than a governmental, actor"); *First Heritage Corp. v. NASD, Inc.*, 785 F. Supp. 1250, 1251 (E.D. Mich. 1992) (holding NASD is not a government entity); *Epstein*, 416 Fed. Appx. at 148 ("[T]he NASD is a private actor, not a state actor"); *Flowers*, 2013 U.S. Dist. LEXIS 21323 (holding NASD is not a state actor); *United States v. Solomon*, 509 F.2d 863, 867–71 (2d Cir. 1975) (holding that the New York Stock Exchange—a self-regulatory private organization like FINRA—is not a state actor); *D.L. Cromwell Invs., Inc. v. NASD Regulation, Inc.*, 279 F.3d 155, 162 (2d Cir. 2002) (stating that it is a well-settled principle that NASD is not a governmental actor), *cert denied by D.L. Cromwell Invs., Inc. v. NASD Regulation, Inc.*, 2002 U.S. LEXIS 8471 (Nov. 18, 2002); *Scher v. NASD*, 386 F.Supp. 2d 402, 407 (S.D.N.Y. 2005) ("Courts have held consistently that 'the NASD is a private actor, not a state actor,' and thus constitutional principles do not apply to its proceedings."); *United States v. Shvarts*, 90 F. Supp. 2d 219, 222 (E.D.N.Y. 2000) ("It is beyond cavil that the NASD is not a government agency; it is a private, not-for-profit corporation."), *abrogated on other grounds by United States v. Coppa*, 267 F.3d 132 (2d Cir. 2001); *Lanzisera*, 2001 U.S. Dist. LEXIS 20646 at *7 ("It is quite clear that neither the NASD nor the two individual Defendants are 'state' actors."); *Perpetual Secs., Inc. v. Tang*, 290 F.3d 132, 138 (2d Cir. 2002) ("It is clear that NASD is not a state actor and its requirement of mandatory arbitration is not state action."); *People v. Cohen*, 187 Misc. 2d 117, 122 (N.Y. Sup. Ct. 2000) ("While Congress certainly provided for comprehensive Federal regulation of the securities industry, and charged the SROs with the duty of self-regulation, the fact that the NASD is subject to extensive oversight by the SEC, and ultimately Federal court review, does not metamorphose the NASD into an organ of the Federal Government."); *Marchiano v. NASD*, 134 F. Supp. 2d 90, 95 (D.D.C. 2001) ("The court is aware of no case—and [plaintiff] has presented none—in which NASD Defendants were found to be state actors either because of their regulatory responsibilities or because of any alleged collusion with criminal prosecutors. In fact, every court that has addressed those issues has rejected [those] arguments."); *Epstein*, 2009 U.S. Dist. LEXIS 29828 at *4–5 ("FINRA, formerly known as NASD, and its employees . . . are not state actors."); *Coleman v. NASD*, 1999 U.S. Dist. LEXIS 7172 (S.D.N.Y. May 12, 1999) ("As NASD is not a state actor, plaintiff's constitutional arguments do not apply. "); *Berger v. SEC*, 347 Fed. Appx. 692, 694 (2d Cir. 2009) ("We have held, however, that NASD is not a state actor subject to due process requirements");

Likewise, the SEC has repeatedly held that SROs including FINRA are not state actors. *See e.g., Timothy H. Emerson*, 2009 SEC LEXIS 2417 at *25; *Scott Epstein*, 2009 SEC LEXIS 217 at *51; *Mission Securities Corp.*, 2010 SEC LEXIS 4053 at *31 n.21; *Kevin M. Glodek*, 2009 SEC LEXIS 3936 at *22–23; *Mark H. Love*, Exchange Act Rel. No. 49248, 2004 SEC LEXIS 318, *21 n.13 (Feb. 13, 2004); *William J. Gallagher*, Exchange Act Rel. No. 47501, 2003 SEC LEXIS 599, *9 n.10 (Mar. 14, 2003); *Timothy P. Pedregon, Jr.*, Exchange Act Rel. No. 61791, 2010 SEC LEXIS 1164, *19 (Mar. 26, 2010); *Asensio & Company, Inc.*, 2012 SEC LEXIS 3954 at *61; *Gregory Evan Goldstein*, 2013 SEC LEXIS 552 at *20; *Richard A. Neaton*, 2011 SEC LEXIS 3719 at *34; *Eric J. Weiss*, 2013 SEC LEXIS 837 at *21 n.40.

securities association under Section 15A of the Exchange Act. FINRA was not created by statute, none of its personnel are government appointees, and it receives no funding from any government, either federal or state.[68] The fact that FINRA is currently the only entity registered as a national securities association under Section 15A does not change that or make FINRA a state actor.[69]

This case does not involve the exercise of power by the federal government or the enforcement of federal regulations. Instead, it is a proceeding to enforce a private agreement by Schwab to abide by specific NASD and FINRA rules.[70] Numerous cases support this

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[68] *See, e.g., Graman,* 1998 U.S. Dist. LEXIS 11624 at *5–6; *Desiderio*, 191 F.3d at 206 ("[T]he NASD is a private actor, not a state actor. It is a private corporation that receives no federal or state funding. Its creation was not mandated by statute, nor does the government appoint its members or serve on any NASD board or committee. Moreover, the fact that a business entity is subject to 'extensive and detailed' state regulation does not convert that organization's actions into those of the state."). *Cf. Pub. Co. Accounting Oversight Bd.*, 130 S. Ct. at 3147 ("Unlike the self-regulatory organizations, however, the Board is a Government-created, Government-appointed entity, with expansive powers to govern an entire industry.").

[69] *See, e.g., Graman v. NASD*, 1998 U.S. Dist. LEXIS 11624 at *7–9 (D. D.C. 1998) ("The fact that the Maloney Act of 1938 welcomed and anticipated the creation of NASD does not make it a governmental actor, any more than Congress' special charter for the United States Olympic Committee made the USOC a governmental actor," citing *San Francisco Arts & Athletics, Inc. v. United States Olympic Comm.*, 483 U.S. 522, 543–44 (1987); "[p]laintiffs contend that NASD's status as the sole regulatory organization for brokers who deal directly with the public confers a special responsibility to abide by the Constitution. But the existence of an effective private monopoly does not create governmental action, even when the monopoly is powerful enough to influence decisions of government itself," citing *National Collegiate Athletic Assoc. v. Tarkanian*, 488 U.S. 179, 198–99 (1988)); *Desiderio v. NASD*, 191 F.3d 198, 206 (2d Cir. 1999) ("[T]he NASD is a private actor, not a state actor. It is a private corporation that receives no federal or state funding. Its creation was not mandated by statute, nor does the government appoint its members or serve on any NASD board or committee. Moreover, the fact that a business entity is subject to 'extensive and detailed' state regulation does not convert that organization's actions into those of the state.").

[70] *Apollo Prop. Partners, LLC v. Newedge Fin., Inc.*, 2009 U.S. Dist. LEXIS 56018, 5–7 (S.D. Tex. Mar. 20, 2009) ("As many courts have held, 'a breach of NASD rules is simply a breach of a private association's rules, although that association is one which is closely related to the SEC[,] . . . [and] therefore [] does not present a question which arises under the laws of the United States.'") (quoting *Lange v. H. Hentz & Co.*, 418 F. Supp. 1376, 1380–81 (N.D. Tex. 1976)); *accord Ford v. Hamilton Inv.*, 29 F.3d 255, 259 (6th Cir. 1994) ("A breach of the NASD rules does not present a question that arises under the laws of the United States within the meaning of 28 U.S.C. § 1331 ."); *Porter v. Shearson Lehman Bros. Inc.*, 802 F. Supp. 41, 61–63 (S.D. Tex. 1992). *See also, e.g., Sparta Surgical Corp. v. NASD*, 159 F.3d 1209, at 1212 (9th Cir. 1998); *In re Prudential Sec., Inc.*, 795 F. Supp. 657, 659 (S.D.N.Y. 1992) ("NASD rules are established and enforced by a private association and do not give rise to federal question jurisdiction"); *Intervest Int'l Equities Corp. v. Aberlich*, 2013 U.S. Dist. LEXIS 45678, *14–15 (E.D. Mich. 2013) ("The contention that the NASD rules were violated absent more does not confer federal question jurisdiction."); 13D Charles Alan Wright, *et al.*, FEDERAL PRACTICE AND PROCEDURE § 3563 n.13 (3d ed. 2008) ("A suit based on breach of the rules of fair trade adopted by the National Association of Security Dealers does not arise under a law of the [United States].")

conclusion. For instance, Judge Posner engaged in a lengthy analysis of whether SRO rules are federal laws in *Bernstein v. Lind-Waldock & Co.* and concluded that they are not.[71] At issue in the case were the rules of the Chicago Mercantile Exchange. Like FINRA's relationship to the SEC and Exchange Act, "the Chicago Mercantile Exchange is closely regulated by the Commodity Futures Trading Commission under the Commodity Exchange Act . . . and the rules of the Exchange must be and are approved by the Commission."[72] Judge Posner held that "[i]t would greatly extend the meaning of the words 'laws . . . of the United States' in 28 U.S.C. § 1331 to so describe the rules of the Chicago Mercantile Exchange."[73]

Moreover, Schwab has not suggested that FINRA has engaged in state action in this case, and it is clear there are no facts in this case that would support such an argument.[74]

Schwab argues that "[t]his action is not a mere membership dispute or purely a *self-*regulatory issue. It is an exercise by Enforcement of disciplinary power delegated by Congress to FINRA under the Exchange Act."[75] However, Congress did not delegate federal law-making or enforcement powers to FINRA in the Exchange Act. FINRA is a private organization that establishes and enforces its own rules.

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[71] 738 F.2d 179 (7th Cir. 1984).

[72] *Id.* at 184.

[73] *Id.*

[74] In fact, Rule 12204(d) "developed from a suggestion made to all self-regulatory organizations (SROs) in a letter dated July 13, 1988" from the outgoing Chairman of the SEC "*ask[ing] SROs to consider* adopting procedures that would give investors access to the courts in appropriate cases, including class actions." Proposed Rule Change, 1992 SEC LEXIS 1566 at *5–6 (emphasis supplied). The NASD initially decided not to propose a rule change but, later, joined the other SROs in adopting the rule proposed by the Securities Industry Conference on Arbitration. *See id.* at *6. These are not facts which suggest the presence of state action. "[E]ven extensive regulation by the government does not transform the actions of the regulated entity into those of the government...[T]he existence of an effective private monopoly does not create government action, even when the monopoly is powerful enough to influence decisions of government itself." *Graman*, 1998 U.S. Dist. LEXIS 11624 at *8–9 (citing *Tarkanian*, 488 U.S. at 198–99 ("Even if we assume that a private monopolist can impose its will on a state agency by a threatened refusal to deal with it, it does not follow that such a private party is therefore acting under color of state law.")). *See also Blum v. Yaretsky*, 457 U.S. 991, 1004 (1982); *Tulsa Professional Collection Servs., Inc. v. Pope*, 485 U.S. 478, 486 (1988).

[75] Schwab Opening Brief at 15–16 (emphasis in original).

This is indeed the structure established by the Exchange Act. FINRA complies with the requirements set out in Section 15A for national securities associations. These include requirements to establish rules that are "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, . . . and, in general, to protect investors and the public interest,"[76] and rules "to provide that . . . its members and persons associated with its members shall be appropriately disciplined" for violations of the Exchange and "the rules of the association."[77] The rules that FINRA establishes pursuant to this provision are FINRA's own rules. As Judge Friendly stated in *United States v. Solomon*, describing the role of a stock exchange acting as a self-regulatory organization: "this is but one of many instances where government relies on self-policing by private organizations to effectuate the purposes underlying federal regulating statutes."[78]

D. SEC Approval of FINRA Rules Does Not Make Them Federal Regulations.

The SEC's approval of SRO rules under Section 19 of the Exchange Act does not make those rules federal regulations.[79] To find otherwise would disregard the detailed statutory framework in the Exchange Act under which private SROs issue their own rules, which are then approved by the SEC under broad statutory standards.[80]

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[76] 15 U.S.C. § 78o-3(b)(6).

[77] *Id.* at § 78o-3(b)(7).

[78] *Solomon*, 509 F.2d at 869.

[79] *See e.g., Bernstein*, 738 F.2d at 184; *Lowe v. NASD Regulation, Inc.*, 1999 U.S. Dist. LEXIS 19489, at *11 (D.D.C. 1999) ("The Plaintiffs are correct in their assertion that federal question jurisdiction may not arise solely because the NASD rules are subject to review by and approval of the SEC."); *Ford*, 29 F.3d at 259; *Cremin*, 957 F. Supp. at 1468 ("[I]t is clear that the SEC's role in reviewing exchange rules, and arbitration rules in particular, does not make them the product of state action."); *Blum*, 457 U.S. at 1005 ("Mere approval of or acquiescence [by the government] in the initiatives of a private party is not sufficient to justify" the finding of state action.).

[80] *See* Section 19(b)(2)(C) of the Exchange Act. Schwab also argues that in bringing this proceeding, FINRA is acting beyond the role provided to it under the Exchange Act. *See, e.g.*, Schwab Opening Brief at 11. This is not true. Rules 2268 and 12204 were approved by the SEC as consistent with the Exchange Act. *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

(*continued to next page . . .*)

If the NAC were to accept Schwab's arguments and hold that FINRA exercised federal law-making powers in adopting the rules at issue in this case and is exercising federal law enforcement powers in bringing this disciplinary proceeding, it would be disregarding unanimous precedent, accepted for decades, that has established the basic principles of self-regulation. Such a ruling would create widespread uncertainty and could have far-reaching unintended consequences. It would raise serious questions about whether FINRA can adopt rules that apply in any way to the arbitration activities of member firms or that regulate the content of firms' PDAAs with customers. That would be an unfortunate result given the role that FINRA plays in the arbitration process and the fact that the rules at issue are intended to ensure the fairness of that process. Indeed, the Supreme Court made clear in *Shearson/American Express, Inc. v. McMahon*[81] that the SEC's oversight of the role played by SROs in the arbitration process was a significant factor in leading the Court to decide that prior concerns raised about the efficacy of the arbitration process in *Wilko v. Swann*[82] were unfounded.[83] Such a

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(. . . *continued from prior page*)
Clauses, SEC Rel. No. 34-26805, 1989 SEC LEXIS 843 (May 10, 1989) (approval of what is now Rule 2268(d)(1); Order Granting Approval to Proposed Rule Change as Amended and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 5 by the National Association of Securities Dealers, Inc., Regarding NASD Rule 3110(f) Governing Predispute Arbitration Agreements with Customers, SEC Rel. No. 34-50713, 2004 SEC LEXIS 2832 (Nov. 22, 2004) (approval of what is now Rule 2268(d)(3); Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change Relating to the Exclusion of Class Actions from Arbitration Proceedings, SEC Rel. No. 34-31371, 1992 SEC LEXIS 2767 (Oct. 28, 1992) (approval of what is now Rule 12204(d)).

[81] 482 U.S. 220 (1987).

[82] 346 U.S. 427 (1953).

[83] The Court in *McMahon* explained:

> In 1953, when *Wilko* was decided, the Commission had only limited authority over the rules governing self-regulatory organizations (SROs)—the national securities exchanges and registered securities associations—and this authority appears not to have included any authority at all over their arbitration rules. *See* Brief for Securities and Exchange Commission as Amicus Curiae 14–15. Since the 1975 amendments to § 19 of the Exchange Act, however, the Commission has had expansive power to ensure the adequacy of the arbitration procedures employed by the SROs. . . . 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.

(*continued to next page* . . .)

ruling would also raise serious questions about whether FINRA is a state actor in other areas of its regulatory activities.

E. The Cases Cited by Schwab Do Not Support the Conclusion that FINRA Rules Are Federal Laws or Regulations.

Schwab supports its argument that FINRA is exercising federal law-making and enforcement powers by cobbling together quotes from various cases that describe FINRA's activities as "exercising powers granted to it under the Exchange Act" or exercising powers "delegated by Congress." However, these cases do not stand for the proposition that FINRA rules are federal law.

1. The Preemption Cases Cited by Schwab Do Not Support Its Position.

For instance, Schwab uses language from a number of cases analyzing preemption issues. However, those cases do not hold that private SRO rules are federal regulations. Instead, they analyze whether the federal statutory framework for regulation of broker-dealers preempts conflicting state law.

The court's decision in *Grunwald*, one of the cases relied on by Schwab, is illustrative. The court's summary of its holding on the issue, rather than the fragmented quotes taken out of context by Schwab, demonstrates this:

> CSFB contends that the Exchange Act preempts application of the California Ethics Standards to NASD-appointed arbitrators. We agree.
>
> Under the Supremacy Clause, federal laws preempt conflicting state laws. Federal regulations issued by an agency in the scope of its congressionally-delegated authority are included among the "Laws of the United States" which can preempt state law. *We deal here, however, with rules adopted by private entities—self-regulatory organizations ("SROs") within the securities industry—rather than federal agencies.* The Exchange Act "delegated government power" to SROs such as the New

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(. . . *continued from prior page*)
482 U.S. at 233–34.

> York Stock Exchange ("NYSE") and the NASD "to enforce . . . compliance by members of the industry with both the legal requirements laid down in the Exchange Act and ethical standards going beyond those requirements."
>
> Whether SRO rules can preempt conflicting state laws is an issue that we have not addressed. In *Merrill Lynch, Pierce, Fenner & Smith v. Ware*, however, the Supreme Court suggested by implication that SRO rules can in certain circumstances have preemptive force despite the fact that they are adopted and enforced by private organizations. 414 U.S. 117, 127, 38 L. Ed. 2d 348, 94 S. Ct. 383 (1973) ("Conflicting law . . . should be pre-empted by exchange self-regulation 'only to the extent necessary to protect the achievement of the aims of the Securities Exchange Act.'" (quoting *Silver v. N.Y. Stock Exch.*, 373 U.S. 341, 361, 10 L. Ed. 2d 389, 83 S. Ct. 1246 (1963)). In light of the Supreme Court's *Ware* decision and the 1975 Amendments to the Exchange Act, we conclude that SRO rules approved by the Commission preempt conflicting state law. Because the NASD arbitration rules at issue here were approved by the Commission and because the California Ethics Standards conflict with the NASD arbitration disclosure rules, the California Ethics Standards are preempted by the NASD rules.

Later in the decision, the court summarized its holding as follows:

> In sum, we conclude that SRO rules that have been approved by the Commission pursuant to 15 U.S.C. § 78s (b)(2) preempt state law when the two are in conflict, either directly or because the state law stands as an obstacle to the accomplishment of the objectives of Congress. Specifically, we hold that the NASD arbitration procedures in dispute here have preemptive force over conflicting state law. . . .
>
> The Exchange Act requires SROs like the NASD to "comply with . . . its own rules." Thus, if the NASD violates its own rules, it likewise violates federal law. By extension, if a state law makes it impossible for the NASD to comply with its own rules, that state law prevents the NASD from complying with federal law.

Thus, the holding of *Grunwald* is not that NASD rules are federal law, but rather that preemption was appropriate because the state law at issue made it impossible for NASD to comply *with the requirement in the Exchange Act to comply with its own rules*. The conflict was with the Exchange Act, and thus preemption was the appropriate result. *Grunwald* also underscores the difference between SRO rules and federal regulations. If the court considered

the two to be the same, its analysis would have ended with its observation that federal regulations preempt conflicting state laws, just four sentences into the excerpt above.

In *McDaniel*, another case relied upon by Schwab, the issue was whether the federal securities laws preempted a California statute prohibiting patronage. A number of brokerage firms had adopted procedures preventing employees from maintaining trading accounts away from the firms. Employees of the firms challenged the policies as forced patronage prohibited by a California statute. The firms argued that the California statute was preempted by federal law, and specifically by the provision in the Exchange Act requiring firms to adopt policies and procedures reasonably designed to prevent the misuse of material, nonpublic information.

The court noted that in addition to the Exchange Act provision, SRO rules "have elaborated on the Act's requirements," citing NASD Rule 3010 and FINRA Rule 3130 as examples. The court ultimately held that "[t]he district courts correctly determined that the Securities Exchange Act and related SRO rules preempt the employees' forced-patronage suits."

As part of the court's discussion of the regulatory framework for broker-dealers, the court stated that "Congress has vested the Financial Industry Regulatory Authority (FINRA, formerly the National Association of Securities Dealers (NASD)) and the New York Stock Exchange (NYSE) with the power to promulgate rules that, once adopted by the SEC, have the force of law." The court cited Section 19(b) of the Exchange Act as support for that statement. Section 19(b) sets outs the procedures for the SEC's consideration and approval of proposed rule changes proposed by SROs.[84]

McDaniel holds that federal regulation of broker-dealer activities preempts conflicting state laws. That is not a new holding and the case breaks no new ground. The case does not

[84] *See* 15 U.S.C. § 78s(b).

hold, as Schwab suggests, that FINRA rules are federal law. The isolated statement quoted by Schwab is simply an observation by the court that SRO rules are approved by the SEC pursuant to the process set out in Section 19(b). Section 19(b) does not make FINRA rules federal law or FINRA a state actor, and the case law is clear on this. That issue and any effect it may have on this proceeding were not under consideration in *McDaniel*. Schwab's argument to the contrary is based on taking an isolated fragment of language out of context.

2. The Immunity Cases Cited by Schwab Do Not Support Its Position.

Schwab also uses language from a number of cases analyzing immunity issues. These cases hold that FINRA and its employees are entitled to immunity when exercising regulatory responsibilities.[85] They do not hold that FINRA is a state actor or that its rules are federal or state laws or regulations. In fact, they hold the opposite. For instance, in *Scher v. NASD*, the court stated:

> [C] ontrary to plaintiff's contention, it is by no means "inconsistent" to find that, on the one hand, the NASD exercises insufficient state action to trigger constitutional protections in a case such as this, while nevertheless holding that the NASD is entitled to absolute immunity in the exercise of its quasi-public regulatory duties.[86]

As with its argument based on preemption cases, Schwab's arguments arising from the immunity cases are based on taking isolated fragments of language out of context.

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[85] *See D'Alessio v. N.Y. Stock Exch., Inc.*, 125 F. Supp. 2d 656,658 (S.D.N.Y. 2000) (noting that absolute immunity "is a matter not simply of logic but of intense practicality, since, in the absence of such immunity, the Exchange's exercise of its quasi-governmental functions would be unduly hampered by disruptive and recriminatory lawsuits").

[86] 386 F.Supp. 2d at 408. *See also Barbara v. N.Y. Stock Exch., Inc.*, 99 F.3d 49, 58 (2d Cir. 1996) ("Although the Exchange is a private, rather than a governmental entity, immunity doctrines protect *private* actors when they perform important *governmental* functions.") (emphases added); *Am. Benefits Group v. NASD*, 1999 U.S. Dist. LEXIS 12321, *8 (S.D.N.Y. Aug. 5, 1999) (holding both that the NASD is entitled to absolute immunity when acting within the scope of its official duties, and that the NASD is not a state actor in its role as a self-regulatory organization).

3. *The State Law Preemption Cases Cited by Schwab Do Not Support Its Position.*

Finally, Schwab cites a number of cases which it argues show that FINRA rules cannot be enforced because they are the same as state regulations or statutes that have been struck down as preempted by federal law. However, those cases employ federal preemption analysis based on the principle that the Supremacy Clause in the U.S. Constitution preempts *state law* that conflicts with federal law. They have no application in this case, which involves private FINRA rules and not state law.

For instance, *Securities Industry Association v. Connolly*[87] dealt with a state regulation that prohibited firms from requiring customers to sign PDAAs. The Court held that federal preemption prohibited application of those regulations by a state: "*no state* may simply subject arbitration to individuated regulation in the same manner as it might subject some other unprotected contractual device."[88] The court's analysis was based on the basic principle that "[t]he Supremacy Clause of Article VI of the federal Constitution prevents the states from impinging overmuch on federal law and policy."[89]

Saturn Distribution Corp. v. Williams[90] held that a Virginia law was preempted by the FAA using the same analysis. The court held that "[t[he FAA preempts 'conflicting *state laws* which restrict the validity of the enforceability of arbitration agreements.'"[91] The holding was based on the well-established principle that "[t]he Supremacy Clause of Art. VI of the

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[87] 883 F.2d 1114 (1st Cir. 1989).

[88] *Id.* at 1120 (emphasis supplied).

[89] *Id.* at 1117.

[90] 905 F.2d 719 (4th Cir. 1990).

[91] *Id.* at 722 (quoting *Supak & Sons Mfg. Co. v. Pervel Indus. Inc.*, 593 F.2d 135, 137 (4th Cir. 1979)) (emphasis supplied).

Constitution provides Congress with the power to pre-empt *state law*."[92]

The same is true of *American Financial Services Association v. Burke.*[93] That case granted a preliminary injunction against a Connecticut statute, holding that "[s]tate law conflicting with Section 2 of the FAA is, pursuant to the Supremacy Clause, preempted and unenforceable."[94]

These cases involve state action and the principle under standard preemption analysis that the Supremacy Clause in Article IV of the Constitution preempts conflicting state law. They have no application in this case. These cases also do not address situations where a firm has entered into an agreement not to undertake the activity at issue, as this case does.

F. This Case Is Not About the Merits or Flaws of Class Actions.

In its *amicus* brief, the Chamber of Commerce argues that class actions do not provide meaningful relief to investors.[95] Schwab has made similar arguments in this case.[96] *Amici* who filed briefs in support of Enforcement argue the opposite, noting a number of class actions in which investors have received settlements providing them with many of millions of dollars in relief.[97] In fact, one of the cases cited in the *amicus* briefs is a class action in which Schwab paid $235 million to investors in 2011.[98] (Later that same year, Schwab adopted the Class Action

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[92] *Id.* (quoting *Louisiana Pub. Serv. Comm'n v. FCC*, 476 U.S. 355, 368 (1986)) (emphasis supplied).

[93] 169 F.Supp. 2d 62 (D. Conn. 2001).

[94] *Id.* at 68. *Bondy's Ford, Inc. v. Sterling Truck Corp.*, 147 F.Supp. 2d 1283 (M.D. Ala. 2001), which is also cited by Schwab, is not relevant at all. The issue in that case was whether the federal Dealer's Day in Court Act, 15 U.S.C. §§ 1221–25, created an exception to the requirements of the FAA. 147 F.Supp. at 1286.

[95] *See* Chamber of Commerce *Amicus* Brief at 2, 15-16 ("[T]he notion that class actions provide meaningful relief to injured investors is a mirage.").

[96] In its Motion for Summary Disposition before the Hearing Panel, for example, Schwab stated "class actions have become known for their abusive, costly and unfair nature. They have become 'lawyer driven' bounty hunts in which the interest of individual plaintiffs are often sacrificed for inordinate amounts of attorneys' fees, resulting in the process being characterized as 'lawyer self-dealing on a grand scale.'" R. 370–71 (Schwab Motion for Summary Disposition at 1–2).

[97] *See Amicus* Brief of AARP at 15–16; *amicus* brief of Barbra Black and Jill Gross at 15–17.

[98] *Id.*

Waiver.) That settlement recovered more than 82% of recognized losses for the California class and 42% of recognized losses for the federal class, while the attorneys' fees were just 7.6 percent of the federal settlement fund and 10.6 percent of the California settlement fund.[99] Schwab's arguments in this proceeding about class actions have been cloaked in high-minded concerns about the societal value of class actions, but Schwab's interest in preventing its customers from filing class actions may stem from different, more business-driven concerns.

Regardless of these views, however, the merits or flaws of class actions are not at issue in this proceeding. This proceeding seeks to enforce FINRA Rule 2268(d) based on the language of that rule. If there are problems with class actions, those should be addressed either in individual cases where abuses arise or through legislative action.[100] Problems or failings that exist or are perceived to exist with class actions should not be addressed by failing to enforce FINRA rules. That would be an inappropriate form of rule nullification.

III. SCHWAB'S CLASS ACTION WAIVER IS VOID UNDER SECTION 29(a) OF THE SECURITIES EXCHANGE ACT OF 1934.

As demonstrated in Enforcement's Opening Brief, Schwab's Class Action Waiver is void under Section 29(a) of the Securities Exchange Act because the Class Action Waiver requires Schwab's customers to waive compliance with Rule 2268(d) and with Rule 12204(d). Schwab's Class Action Waiver is therefore void under Section 29(a).

Schwab makes two arguments to avoid this straightforward result. First, Schwab claims

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[99] *See In re Charles Schwab Sec. Litig.*, No. C08-01510 WHA, 2011 WL 1481424, at *5, *11 (N.D. Cal. Apr. 19, 2011) (describing the settlement as "a very good result for the class.").

[100] In addressing issues concerning securities class actions recently in *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds,* 133 S. Ct. 1184, 1200–01 (2013) the Supreme Court noted that Congress has "recognized that although private securities-fraud litigation furthers important public-policy interests, prime among them, deterring wrongdoing and providing restitution to defrauded investors, such lawsuits have also been subject to abuse." As the Court noted, however, Congress' reaction to these problems has been to attempt to remedy them through legislation—including the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995), and the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (1998)—not to eliminate them.

that "there is no actual conflict between a class action waiver and any of FINRA's Rules."[101] Schwab is wrong on this point, as discussed above.[102] Second, Schwab claims that "Section 29(a) has already been held not to contain sufficient language to override the FAA," citing the Supreme Court's decision in *McMahon*.[103] Schwab is wrong on this point also.

Section 29(a) of the Exchange Act provides as follows:

> Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder, or of any rule of a self-regulatory organization, shall be void.[104]

Section 29(a) thus voids any contractual provision that waives "substantive obligations imposed by" the Exchange Act, SEC rules and regulations, or SRO rules.[105]

Schwab attempts to "dispose of" Section 29(a) here by asserting that the Supreme Court in *McMahon* "rejected" a "challenge to predispute arbitration agreements on the grounds that such agreements required customers to waive compliance with the protections of the Exchange Act."[106] But Schwab's sweeping and inaccurate description of *McMahon* hides the most important aspect of the Court's holding.

As explained by Enforcement in its Opening Brief, the Court in *McMahon* rejected the argument that a predispute arbitration agreement was void under Section 29(a) because the agreement waived compliance with Section 27 of the Exchange Act—the section vesting

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[101] Schwab Opening Brief at 25.

[102] *See* pages 8–14 *supra.*

[103] 482 U.S. 220. *See* Schwab Opening Brief at 25.

[104] 15 U.S.C. § 78cc(a).

[105] *McMahon*, 482 U.S. at 228. *See also AES Corp. v. Dow Chemical Co.*, 325 F.3d 174, 180 (3d Cir. 2003) ("Section 29(a) of the Exchange Act . . . forecloses anticipatory waivers of compliance with the duties imposed by Rule 10b-5," holding that a provision in a contract stating that it did not rely on any statements by the seller is void because "it purports anticipatorily to waive any future claim based on fraudulent misrepresentations of that party"); *Rogen v. Ilikon*, 361 F.2d 260 (1st Cir. 1966).

[106] Schwab Opening Brief at 25. Schwab also claims that, in *McMahon*, "the Court found that the Exchange Act lacked any Congressional command to override arbitration agreements." *Id.* at 8.

exclusive jurisdiction of suits for violations of the Exchange Act in U.S. district courts.[107] But the Court rejected that argument because Section 27 "itself does not impose any duty with which the persons trading in securities must 'comply.'"[108] Thus, the basis for the holding in *McMahon*—that Section 27 does not create a substantive obligation—is far narrower than Schwab argues.

Indeed, Schwab ignores the portion of the *McMahon* decision in which Supreme Court held that Section 29(a) "prohibits waiver of . . . substantive obligations"[109] and fails to address the nature of the obligations imposed by FINRA Rules 2268(d) and 12204(d).[110] Doing so reveals why Schwab has failed to address these matters: they are fatal to Schwab's position.

First, Section 29(a) by its terms applies to "*[a]ny* condition, stipulation, or provision binding *any* person"[111]— plainly covering the Class Action Waiver, which is a provision in Schwab's agreement with its customers.[112] Second, Section 29(a) "prohibits waiver of the substantive obligations,"[113] and FINRA Rules 2268(d) and 12204(d) impose substantive obligations, unlike Section 27 of the Exchange Act.[114] Since Schwab's Class Action Waiver seeks a waiver from the customer of compliance with the substantive requirements imposed by

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[107] 15 U.S.C. § 78aa.

[108] *McMahon*, 482 U.S. at 228.

[109] 482 U.S. at 228.

[110] Instead, Schwab relies on conclusory assertions like "i[f] arbitration agreements are not invalid waivers of customers' supposed rights to have their disputes heard in court under the Exchange Act, then arbitration agreements cannot be invalid waiver of customers' supposed rights to have their supposed rights to have their disputes heard in court under FINRA Rules whose sole sources of authority is the Exchange Act itself."

[111] 15 U.S.C. § 78cc(a) .

[112] Indeed, because § 29(a) of the Exchange Act was first enacted in 1934, nine years after the enactment of the FAA, the phrase "any condition, stipulation, or provision binding any person" plainly refers to any provision in an arbitration agreement covered by the FAA.

[113] *McMahon*, 482 U.S. at 228.

[114] Rules 2268(d) and 12204(d) impose a duty on FINRA member firms to refrain from limiting the ability of customers to file claims in court that are permitted to be filed in court under the rules of FINRA arbitration. *See* pages 3–8, *supra.*

Rule 2268(d) and Rule 12204(d), it is void under Section 29(a) of the Exchange Act.

Moreover, the Congressional intent behind Section 29(a) of the Exchange Act is clear from the language of that section.[115] Section 29(a) is unambiguous and does not carve out arbitration agreements for special treatment. Rather, it voids "*any* . . . provision" that purports to waive substantive obligations created by the Exchange Act, SEC rules and regulations, or SRO rules.[116] The Supreme Court has held that the FAA may be "overridden by a contrary congressional command."[117] As described above, Section 29(a) reflects such a clear Congressional command to override the FAA where, like here, the provisions of an arbitration agreement waive a substantive obligation created by SRO rules.[118]

IV. AN EVIDENTIARY HEARING IS NOT NECESSARY TO DETERMINE THE APPROPRIATE SANCTIONS.

Schwab asks that the NAC remand the case to the Hearing Panel if it finds violations as to the First and Second Causes of Action, so the Panel can conduct an evidentiary hearing.[119] That is not necessary. The record contains all of the facts needed for the NAC to make

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[115] *See, e.g., Greenlaw v. United States*, 554 U.S. 237, 258 (2008) ("[T]he text of the relevant statute provides the best evidence of congressional intent."); *A T. Massey Coal Co. v. Barnhart*, 472 F.3d 148, 172 (4th Cir. 2006) ("The statutory text is quite clearly the best evidence of congressional intent and, therefore, judicial inquiry ends with the conclusion that the statute is clear and unambiguous."); *McMillan v. Collection Professionals, Inc.*, 455 F.3d 754, 762 (7th Cir. 2006) ("[T]he text of the statute itself, . . . as we have stated, 'is the most reliable indicator of congressional intent,'" quoting *Bass v. Stolper, Koritzinsky, Brewster & Neider, S.C.*, 111 F.3d 1322, 1324–25 (7th Cir. 1997)); *United States v. Hess*, 194 F.3d 1164, 1175 (10th Cir. 1999) ("The best evidence of Congressional intent is the text of the statute itself and where the language is unambiguous, our inquiry is complete.") (quotation omitted).

[116] *See* 15 U.S.C. § 78cc(a) (emphasis supplied).

[117] *CompuCredit Corp. v. Greenwood*, 132 S. Ct. 665, 669 (2012) (quoting *McMahon*, 482 U. S. at 226).

[118] Indeed, unlike the statutory provision at issue in *CompuCredit*, it is not "a considerable stretch to regard [§ 29(a)] as a 'congressional command' that the FAA shall not apply," *id.* at 226, because § 29(a) clearly and explicitly voids "*any*" provision—including those in arbitration agreements—that waives compliance with SRO rules. Enforcement notes that Schwab inexplicably, and without citation, asserts that "Enforcement . . . concedes that the Exchange Act contains no such [clear congressional] command." Schwab Opening Brief at 10. That statement is false. Enforcement made no such concession either below or in its Opening Brief. Rather, Enforcement stated, in discussing the § 29(a) in its Opening Brief, that "[i]t is a *Congressional directive* to prohibit and make void agreements such as Schwab's Class Action Waiver." Enforcement Opening Brief at 31 (emphasis supplied).

[119] Schwab Opening Brief at 27.

appropriate sanctions determinations. The undisputed facts show the language used by Schwab in its Class Action Waiver, how the provision was used, when it was used, and the number of customer accounts in which it was used. The undisputed facts also show that the conduct is ongoing and deliberate. These facts demonstrate the violations, and the scope and magnitude of the violations.[120]

In addition, the "evidence" that Schwab asserts it would introduce is either not relevant or is argument instead of evidence.[121] No hearing is necessary for Schwab to make those arguments. It has already done so in numerous filings in this case.

V. THE SANCTIONS IMPOSED BY THE HEARING PANEL FOR THE THIRD CAUSE OF ACTION ARE APPROPRIATE AND WARRANTED BY SCHWAB'S CONDUCT.

Schwab argues that the sanctions imposed by the Hearing Panel for the Third Cause of Action are "unnecessary and unfair."[122] The Hearing Panel fined Schwab $500,000, ordered Schwab to stop using the language in its customer agreements, and ordered Schwab to notify in writing all customers who received the language that it is not effective. As demonstrated by Enforcement in its Opening Brief, these are appropriate sanctions under the circumstances of this case and the Sanction Guidelines. Schwab placed the violative language in customer agreements for nearly seven million accounts. The violations were widespread, the firm acted intentionally, and its actions were a deliberate effort to mislead customers to believe they could not seek

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[120] As explained in Enforcement's previous filings both in this appeal and below, Enforcement recommends that the NAC impose a fine of $10 million for all of Schwab's violative conduct, that it stop using the language in its customer agreements that violates FINRA Rule 2268(d), and that it be required to inform all customers who have received the language that it is incorrect and violates FINRA Rules. *See e.g.*, Enforcement Opening Brief at 31–37; R. 243–47 (Enforcement's Motion for Summary Disposition at 25–29).

[121] For instance, Schwab seeks to show that it that it did not receive guidance from FINRA, to show the benefits of arbitration, to show that it has not used the Class Action Waiver in court, and to argue that it relied on the Supreme Court's decision in *Concepcion* in adopting the waiver. *See, e.g.*, Schwab Opening Brief at 27; R. 880–83 (Schwab's Opposition to Enforcement's Motion for Summary Disposition at 20–23). *See* discussion at page 38 and footnotes 123 & 124, *infra.*

[122] Schwab Opening Brief at 48.

consolidation of claims in arbitration.

Schwab argues that the Panel failed to give it credit for acting in good faith, since it did not receive a warning from FINRA not to adopt the Class Action Waiver. This argument—that it is FINRA's responsibility to provide warnings to firms before they commit violations—is baseless and has routinely been rejected by the NAC and the SEC.[123]

Schwab also argues that it should not be sanctioned because the anti-consolidation language was included in the class action waiver in the *Concepcion* case. In fact, the *Concepcion* decision does not address the anti-consolidation language at issue in the Third Cause of Action. In addition, *Concepcion* did not involve conduct by a FINRA member acting contrary to FINRA rules. FINRA has a rule that directly controls the activity at issue (entitled "Requirements When Using Predispute Arbitration Agreements for Customer Accounts") and an extensive set of rules governing the arbitration activities of member firms. Schwab has not pointed to any effort it undertook to obtain clarification before it included language in nearly seven million customer agreements depriving customers of rights provided to them under FINRA rules, if it in fact was unclear about its obligations under FINRA rules after *Concepcion.*[124]

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[123] *See e.g., DOE v. Domestic Securities, Inc.*, Complaint No. 2005001819101, 2008 FINRA Discip. LEXIS 44, at *18 (NAC Oct. 2, 2008) ("[I]t is well settled that members may not shift their responsibility to FINRA for compliance with FINRA's rules."); *East/West Sec. Co.*, Exchange Act Rel. No. 43479, 2000 SEC LEXIS 2293, at *9 & *9 n.13 (Oct. 25, 2000) (rejecting as a defense to a rule violation the assertion that FINRA provided inadequate guidance); *DOE v. Harvest Capital Investments, LLC*, Complaint No. 2005001305701, 2008 FINRA Discip. LEXIS 45, at *44 (NAC Oct. 6, 2008) ("Further, respondents cannot shift the blame for their misconduct onto FINRA staff."); *Donner Corp. Int'l*, Exchange Act Rel. No. 55313, 2007 SEC LEXIS 334, at *64 (Feb. 20, 2007) (holding that "a broker-dealer cannot shift its responsibility for compliance with applicable requirements to the NASD"); *W.N. Whelen & Co., Inc.*, Exchange Act Release No. 28390, 1990 SEC LEXIS 3029, at *4(Aug. 28, 1990) ("[A] securities dealer cannot shift its compliance responsibility to the NASD. A regulatory authority's failure to take early action neither operates as an estoppel against later action nor cures a violation.").

[124] Schwab's failure to understand the requirements of NASD and FINRA rules is no defense. *See Thomas C. Kocherhans*, Exchange Act Release No. 36556, 1995 SEC LEXIS 3308 at *9–10 (Dec. 6, 1995) ("We have repeatedly held that ignorance of NASD requirements is no excuse for violative behavior. Participants in the securities industry must take responsibility for compliance with regulatory requirements and cannot be excused for lack of knowledge, understanding, or appreciation of these requirements. Moreover, we have repeatedly held that a respondent cannot shift his or her responsibility for compliance with an applicable requirement to a supervisor, or to

(*continued to next page . . .*)

Schwab's arguments that it is entitled to credit for acting in good faith are baseless.

Schwab also argues that there is no proof that it has used the Class Action Waiver to harm customers. This argument ignores the obvious *in terrorem* effect the language is intended to have when placed in account agreements for millions of customers. The obvious intended effect is to lead customers to believe that they have given up the right to consolidate claims of more than one party in arbitration, to persuade customers not to seek to consolidate their claims, and to take the anti-consolidation provision into account in settling claims they may otherwise have pursued. That is the purpose of including such a provision in account agreements.

Finally, Schwab argues that the Panel should have given it credit because it eventually removed the anti-consolidation provision from its customer agreements. But Schwab did not remove the language until January 2013, more than eleven months after this disciplinary action was initiated.[125] Schwab should not receive credit for this belated action. Taking corrective action almost a year after the initiation of enforcement action is not a mitigating factor.[126]

Given the scope and nature of the violations, the Hearing Panel's imposition of sanctions for the Third Cause of Action was appropriate and warranted by Schwab's conduct.

(. . . *continued from prior page*)
the NASD," collecting precedent) (citations omitted); *Kirk A. Knapp*, Exchange Act Release No. 31556, 1992 SEC LEXIS 2971, *46–47 (Dec. 3, 1992) ("The NASD is correct in emphasizing that participants in the industry must take responsibility for their compliance and cannot be excused for lack of knowledge, understanding or appreciation of these requirements. Participation in the industry carries with it substantial responsibilities to the public who entrust their funds. Failure to satisfy these responsibilities cannot be excused by pointing the finger of blame at employees who do not have the authority to prevent the alleged violations or the NASD.").

[125] As pointed out in Enforcement's Opening Brief, Schwab also sought to brush aside concerns about the language during the proceeding below by asking the Hearing Panel to accept its casual statements that it would not take advantage of its violative conduct. R. 399 (Schwab's Motion for Summary Disposition at 30); R. 2274–75 (Transcript of oral argument on motions for summary disposition at 32–33).

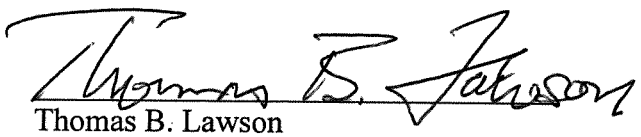
[126] Principal Consideration No. 2 urges adjudicators to consider "[w]hether an individual or member firm respondent accepted responsibility for and acknowledged the misconduct . . . *prior to detection*," and Principal Consideration No. 4 urges consideration of "[w]hether the respondent voluntarily and reasonably attempted, *prior to detection and intervention*, to . . . remedy the misconduct." *See* FINRA Sanction Guidelines (2011 ed.) at 6 (emphasis supplied).

CONCLUSION

For the reasons stated above and in Enforcement's Opening Brief, the NAC should affirm the Hearing Panel's decision that Schwab's Class Action Waiver violates NASD and FINRA rules as charged in the First and Second Causes of Action of the Complaint. The NAC should also reverse the Hearing Panel's finding that the FAA prevents FINRA from enforcing these rule violations and should impose the sanctions requested by Enforcement. The NAC should also affirm the Hearing Panel's finding that Schwab's placement of language in its customer agreements providing that arbitrators do not have authority to consolidate more than one party's claims violated NASD and FINRA rules, as charged in the Third Cause of Action. The NAC should affirm the Hearing Panel's imposition of a $500,000 fine for that violation and its order that Schwab to stop using the language and notify all customer who received it that it is not effective.

Dated: June 19, 2013

Respectfully submitted,



Thomas B. Lawson
Christopher A. Perrin
Daniel L. Gardner
FINRA Department of Enforcement
15200 Omega Drive
Rockville, Maryland 20850
301-258-8551 (Lawson voice)
202-721-8336 (Lawson fax)
thomas.lawson@finra.org

CERTIFICATE OF SERVICE

I hereby certify that on June 19, 2013, I caused a copy of the foregoing Department of Enforcement's Reply Brief to be sent by email and First Class U.S. mail to counsel for Respondent at the addresses below:

Gilbert R. Serota
Julian Y. Waldo
Arnold & Porter LLP
3 Embarcadero Center, 7th Floor
San Francisco, CA 94111-4024
gilbert.serota@aporter.com
julian.waldo@aporter.com

Lowell Haky
Charles Schwab & Co.
211 Main Street
San Francisco, CA 94105
lowell.haky@schwab.com
(via email only)

Daniel L. Gardner
Principal Counsel
15200 Omega Drive
3rd Floor
Rockville, MD 20850-3241