Regulatory Notice 21-16

Predispute Arbitration Agreements in Customer Agreements

FINRA Reminds Members About Requirements When Using Predispute Arbitration Agreements for Customer Accounts

Summary

FINRA reminds member firms about requirements when using predispute arbitration agreements for customer accounts. Where member firms use mandatory arbitration clauses in their customer agreements, FINRA rules establish minimum disclosure requirements regarding the use of such clauses and prohibit predispute arbitration agreements from including conditions that, among other things, limit or contradict FINRA rules. In addition, FINRA rules do not allow class action claims in FINRA arbitration. Accordingly, FINRA rules prohibit member firms from incorporating provisions that would prevent customers from bringing or participating in judicial class actions by adding waiver language into customer agreements (class action waivers) and prohibit member firms from enforcing arbitration agreements against members of a certified or putative class action. FINRA urges member firms to take prompt steps to ensure their customer agreements fully comply with FINRA rules. Member firms that fail to comply with FINRA rules related to customer agreements may be subject to disciplinary action.

Questions concerning this *Notice* should be directed to:

- Victoria Crane, Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-8104 or *Victoria.Crane@finra.org*;
- Thomas Kimbrell, Associate General Counsel, OGC, at (202) 728-6926 or *Thomas.Kimbrell@finra.org*; or
- Kristine Vo, Principal Counsel, OGC, at (212) 858-4106 or *Kristine.Vo@finra.org*.

April 21, 2021

Notice Type

- Guidance

Suggested Routing

- Compliance
- Legal
- Registered Representatives
- Senior Management

Key Topics

- Arbitration
- Code of Arbitration Procedure
- Customer Agreements
- Dispute Resolution
- Forum Selection Provisions
- Predispute Agreements
- Predispute Arbitration Agreements

Referenced Rules & Notices

- FINRA Rule 2010
- FINRA Rule 2268
- FINRA Rule 12200
- FINRA Rule 12204
- FINRA Rule 12206
- FINRA Rule 12213
- FINRA Rule 12402
- FINRA Rule 12403
- FINRA Rule 12503
- Notice to Members 05-09
- Notice to Members 92-65
- Notice to Members 95-16
- Notice to Members 95-85
- Regulatory Notice 16-25
- Securities Exchange Act Section 29

Background & Discussion

FINRA rules do not require customers to enter into agreements to arbitrate disputes with member firms, nor do FINRA rules preclude customers from pursuing relief in state or federal courts. Most member firms, however, require customers opening accounts to agree in writing to arbitrate eligible disputes concerning the account.[1] Under FINRA rules, arbitration in the FINRA forum is required if there is a written agreement requiring FINRA arbitration or if it is requested by the customer.[2]

When member firms use mandatory arbitration clauses, FINRA rules establish minimum disclosure requirements regarding their use to help ensure customers understand these clauses, and to protect customers' rights under FINRA rules. These requirements, set forth in FINRA Rule 2268, include that any predispute arbitration clause must be highlighted in the customer agreement and immediately preceded by disclosures that the customer agreement contains such a clause and that describe the consequences of agreeing to arbitration.[3]

In addition, FINRA Rule 2268 prohibits any predispute arbitration agreement from including any condition that: (1) limits or contradicts the rules of any self-regulatory organization (SRO);[4] (2) limits the ability of a party to file any claim in arbitration; (3) limits the ability of a party to file any claim in court permitted to be filed in court under the rules of the forums in which a claim may be filed under the agreement; or (4) limits the ability of arbitrators to make any award.[5] These requirements make clear that predispute arbitration agreements must preserve customers' rights under FINRA rules.

Recently, as discussed below, FINRA has become aware that customer agreements used by some member firms contain provisions that do not comply with FINRA rules. Member firms with customer agreements that include provisions that do not comply with FINRA rules should take prompt steps to ensure that their customer agreements fully comply with FINRA rules. Failing to comply with FINRA rules related to customer agreements may subject member firms to disciplinary action.[6]

This *Notice* provides examples of provisions in customer agreements that do not comply with FINRA rules; however, the provisions in customer agreements that potentially do not comply with FINRA rules are not limited to those discussed in this *Notice*.

Hearing Locations

Some customer agreements attempt to dictate the location of the arbitration hearing.[7] For example, some customer agreements require the hearing to be held in a particular state, regardless of where the customer resides. Any such provision does not comply with FINRA Rule 12213, which provides that the Director of Dispute Resolution Services will decide which of FINRA's hearing locations will be the hearing location for the arbitration. Generally, the Director will select the hearing location closest to the customer's residence

at the time of the events giving rise to the dispute, unless the hearing location closest to the customer's residence is in a different state, in which case the customer may request a hearing location in the customer's state of residence at the time of the events giving rise to the dispute.[8] Customer agreements cannot be used to restrict the location of an arbitration hearing contrary to FINRA rules.[9]

Time Limitations

Some customer agreements attempt to shorten or extend applicable statutes of limitations. FINRA Rule 12206 allows arbitration claims to be submitted unless six years have elapsed from the occurrence or event giving rise to the claim. The arbitrator or panel resolves any questions regarding the eligibility of a claim under this rule or under an applicable state statute of limitations. Consequently, customer agreements may not be used to shorten or extend statutes of limitations or require that a question of whether a time limitation applies be judicially determined instead of being submitted to an arbitrator or panel under the Code of Arbitration Procedure for Customer Disputes (Customer Code).

Class Action Claims

Some customer agreements attempt to limit a customer's right to pursue class actions in court. Examples include customer agreements that state that the customer waives any right to bring a class action; customer agreements that state that any claims between the parties must be brought in an individual capacity; and customer agreements that state broadly that the agreement to arbitrate constitutes a waiver of the right to seek a judicial forum, without sufficiently indicating that class actions are excepted from this waiver. As described below, limiting a customer's right to pursue class actions in court through a customer agreement, or seeking to enforce such an agreement, does not comply with FINRA rules.

Specifically, FINRA Rule 12204(a) provides that class action claims may not be arbitrated under the Customer Code, and FINRA Rule 12204(d) prohibits member firms and associated persons from enforcing arbitration agreements against members of a certified or putative class action until certain events such as the denial of class certification occur. Consistent with FINRA Rule 12204, FINRA Rule 2268(f) requires that all customer agreements include a statement that:

> "No person shall bring a putative or certified class action to arbitration, **nor 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. Such forbearance to enforce an agreement to arbitrate shall not constitute a waiver of any rights under this agreement except to the extent stated herein."[10] (emphases added).

FINRA crafted Rule 12204 to prevent member firms from using an existing arbitration agreement to defeat class certification or participation.[11] In approving FINRA Rules 12204 and 2268, the SEC stated 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."[12] FINRA Rules 2268(d)(1) and d(3) prohibit member firms from incorporating class action waivers into their customer agreements.[13]

As stated above, member firms with provisions in customer agreements that do not comply with FINRA rules may be subject to disciplinary action. For example, in 2014, FINRA issued a decision finding that a firm violated FINRA rules when it inserted provisions in predispute arbitration agreements that prevented customers from bringing or participating in judicial class actions.[14]

Claims and Awards

Some customer agreements attempt to limit the ability of a customer to file a claim or to limit the authority of the arbitrators to make an award, including, for example, through provisions that purport to limit the member firm's liability for consequential or punitive damages, or damages that do not arise from the member firm's gross negligence or intentional misconduct. Other customer agreements attempt to do so indirectly by incorporating a choice of law or governing law clause. However, "if a choice of law provision is used, there must be an adequate nexus between the law chosen and the transaction or parties at issue in accordance with *Notices to Members* *95-85* and *95-16*."[15] Including a choice of law or governing law clause in a customer agreement without an adequate nexus, which suggests an intent to limit an award, or otherwise including provisions that attempt to limit the ability of a customer to file a claim or the authority of arbitrators to make an award, is a prohibited condition under FINRA Rule 2268(d).[16]

Indemnity and Hold Harmless Provisions

Some customer agreements contain indemnification or hold harmless provisions, such as broad provisions that require that the customer indemnify and hold harmless the member firm from all claims and losses arising out of the agreement. Indemnification and hold harmless provisions do not comply with FINRA Rule 2268 where the provisions, if given effect, would limit the customer from bringing a claim or receiving an award from the member firm or associated person that they would otherwise be entitled to receive. For example, an indemnification and hold harmless provision that could be invoked to assert that a customer could not bring a claim alleging a failure to supervise against a member firm that the customer would otherwise be entitled to bring under applicable law would not comply with FINRA Rule 2268.

In addition, a well-developed line of case law has held that it is contrary to public policy for a person to seek indemnity from a third party for that person's own violation of the federal securities laws.[17] Accordingly, FINRA believes that it would be unethical and not in compliance with FINRA Rule 2010 for a member firm or associated person to attempt to seek indemnity from customers of costs or penalties resulting from the firm's or associated person's own violation of the securities laws or FINRA rules.[18] For example, FINRA believes that a member firm would violate FINRA Rule 2010, and be subject to disciplinary action, if it sought to recover from a customer the attorney's fees that it incurred as a result of a regulatory investigation into the member firm's own misconduct.

Endnotes

1. The Supreme Court has held that predispute arbitration agreements are enforceable as to claims brought under the Securities Exchange Act of 1934 (Exchange Act). *See Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987). As a result of *McMahon*, firms can today compel arbitration of customer claims through inclusion of predispute arbitration provisions in their customer agreements.

   Section 921 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), authorizes the Securities and Exchange Commission (SEC) to "prohibit, or impose conditions or limitations on the use of agreements that require customers or clients of any broker, dealer, or municipal securities dealer to arbitrate any future dispute between them arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors."

2. *See* FINRA Rule 12200; *see also* Regulatory Notice 16-25 (July 2016) (reminding member firms that customers have a right to request arbitration at FINRA at any time and do not forfeit that right under FINRA rules by signing any agreement specifying another dispute resolution process or venue). Even with a predispute arbitration agreement, member firms and customers may elect, by mutual consent, to resolve their disputes in a forum other than at FINRA, such as at a private arbitration forum or by civil litigation, *after* a dispute has arisen between the parties. Similarly, if a written agreement to arbitrate at FINRA does not exist and the customer does not request FINRA arbitration, the parties to a dispute may proceed to agree to resolve their disputes at a private arbitration forum or in civil litigation.

   FINRA's primary role in the arbitration process is to administer cases brought to the forum in a neutral, efficient and fair manner. In its capacity as a neutral administrator of the forum, FINRA does not have any input into the outcome of arbitrations.

3. *See* FINRA Rule 2268(a).

4. In addition, pursuant to Section 29(a) of the Exchange Act, any condition, stipulation, or provision binding any person to waive compliance with any provision of an SRO's rules shall be void.

5. *See* FINRA Rule 2268(d).

6. *See Notice to Members (NTM) 95-16* (March 1995) (alerting member firms that some members' customer agreements contain provisions contrary to FINRA rules relating to hearing location, arbitration panel composition, time limitations, claims, and arbitrator's authority to make an award); *NTM 95-85* (October 1995) (clarifying the meaning and application of certain statements in *NTM 95-16* relating to customer agreements containing a "governing law clause," a designated hearing location, and arbitrator panel composition and reminding member firms to review their customer agreements and ensure that they comply with FINRA rules); *Regulatory Notice 16-25* (July 2016) (reminding member firms that customers have a right to request arbitration at FINRA at any time and do not forfeit that right under FINRA rules by signing any agreement specifying another dispute resolution process or venue).

7. FINRA currently offers 69 hearing locations for FINRA arbitrations and mediations, including one in each state of the United States, and one in Puerto Rico.

8. FINRA Rule 12213(a) provides that before arbitrator lists are sent to the parties under FINRA Rules 12402(c) or 12403(b), the parties may agree in writing to a hearing location other than the one selected by the Director. The Director may change the hearing location upon motion of a party, as set forth in FINRA Rule 12503. After the panel is appointed, the panel may decide a motion relating to changing the hearing location. *See* FINRA Rules 12213(a)(2) through (a)(4).

9. In approving the predecessor to FINRA Rule 2268, the SEC noted that customer agreements "may not be used to restrict the situs of an arbitration hearing contrary to SRO rules." *See* Exchange Act Release No. 26805 (May 10, 1989), 54 FR 21144, 21154 (May 16, 1989) (Order Approving File Nos. SR-NYSE-88-29; SR-NYSE-88-8; SR-NASD-88-29; SR-NASD-88-51; SR-NASD-89-19; SR-AMEX-88-29) (approving SROs' proposed rule change relating to the use of predispute arbitration clauses in arbitration); *see also NTM 95-16* ("Customer agreements used by some members attempt to dictate the location for the arbitration hearing .... Any such provision is inconsistent with [the] NASD Code of Arbitration Procedure"); *NTM 95-85* ("Question No. 7: May a firm designate a hearing location for self-regulatory organization (SRO) arbitrations in its arbitration clause? Answer: No.").

10. In announcing the SEC's approval of FINRA Rule 12204, FINRA noted that the rule changes were developed in accordance with the SEC's view, articulated by former SEC Chairman David Ruder, that investors should have access to the courts in appropriate cases. *See* NTM 92-65 (December 1992).

11. *See* Exchange Act Release No. 31371 (October 28, 1992), 57 FR 52659, 52660 (November 4, 1992) (Order Approving File No. SR-NASD-92-28) (approving NASD's proposed rule change relating to the exclusion of class actions from arbitration proceedings).

12. *See* 57 FR 52659, 52661, *supra* note 11.

13. *See Dep't of Enf't v. Charles Schwab & Co.,* No. 2011029760201, 2014 FINRA Discip. LEXIS 5, at *36-39, 73 (FINRA Bd. of Gov. Apr. 24, 2014).

14. *See Schwab*, 2014 FINRA Discip. LEXIS 5, at *73.

15. Exchange Act Release No. 50713 (November 22, 2004), 69 FR 70293, 70295 (December 3, 2004) (Order Approving File No. SR-NASD-98-74) (approving NASD's proposed rule change, including amendments clarifying the prohibition against predispute arbitration agreements that limit rights or remedies); *see also* NTM 05-09 (January 2005) (announcing approval of the proposed amendments discussed in File No. SR-NASD-98-74); *NTM 95-85* (October 1995) (describing how customer agreements may only contain a governing law clause if there is an appropriate contact or relationship between the transaction at issue or the parties and the law selected; and the clause is otherwise consistent with FINRA rules (for example, neither the governing law clause, nor any other clause in the customer agreement, limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award)); *NTM 95-16* (March 1995).

16. *See* 54 FR 21144, 21154, *supra* note 9 ("If punitive damages or attorneys fees would be available under applicable law, then the agreement cannot limit parties' rights to request them, nor arbitrators' rights to award them"); *see also A.G. Edwards & Sons,* AWC No. EAF0400790002 (Sept. 25, 2006) (disciplining member firm for including in its customer agreements a provision that provided the customer would be responsible for member firm's costs and attorney's fees in the event a customer brings a claim against the firm).

17. *See, e.g., First Golden Bancorporation v. Weiszmann,* 942 F.2d 726, 728-29 (10th Cir. 1991) (describing how "[c]ourts have rejected indemnity for a variety of securities violations because indemnity contravened the public policy enunciated by the federal securities laws") (citations omitted).

18. FINRA Rule 2010 requires a member, "in the conduct of its business," to adhere to "high standards of commercial honor and just and equitable principles of trade." The rule "states broad ethical principles and centers on the ethical implications of conduct [and] serves as an industry backstop for the representation, inherent in the relationship between a securities professional and a customer, that the customer will be dealt with fairly and in accordance with the standards of the profession." *Steven Robert Tomlinson*, Exchange Act Release No. 73825, 2014 SEC Lexis 4908, at *17 & nn.17-19 (December 11, 2014) (citations omitted), *aff'd,* 637 F. App'x. 49 (2d Cir. 2016).