ON THE CASE
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3rd Circuit rules banks can't push clients out of FINRA arbitration, breaks with 2nd, 9th

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(Reuters) - In 2016, after two federal appellate courts upheld forum selection clauses requiring issuers of auction-rate securities to go to court with claims against underwriter Goldman Sachs, the Financial Industry Regulatory Authority felt compelled to issue a stern reminder to the banks and brokerages in its membership: When they run into disputes with customers, FINRA said, they're supposed to use FINRA arbitration to resolve the issues. The industry self-regulator warned its members that their customers can't sign away their FINRA arbitration rights in forum selection clauses – and insisted that banks and brokerages shouldn't ask them to.

"FINRA is concerned ... that member firms are requiring customers to sign pre-dispute arbitration agreements or otherwise enter into agreements that include exclusive forum selection provisions," the guidance said. "FINRA reminds member firms that customers have a right to request arbitration at FINRA's arbitration forum at any time and do not forfeit that right under FINRA rules by signing any agreement with a forum selection provision."

On Tuesday, the 3rd U.S. Circuit Court of Appeals endorsed FINRA's campaign against broker-dealers' forum selection clauses. Splitting with the 2014 decisions from the 2nd and 9th Circuits that prompted the regulator's 2016 guidance, the 3rd Circuit ruled in Reading Health System v. Bear Stearns that broker-dealers can't avoid FINRA arbitration via forum selection clauses that do not specifically mention waiver of arbitration rights.

"Reading's right to arbitrate is not contractual in nature, but rather arises out of a binding, regulatory rule that has been adopted by FINRA and approved by the SEC," wrote Judge Jane Roth for a panel that also included Judge **Patty Shwartz** and U.S. District Judge **Gerald Pappert** of Philadelphia, sitting by designation. "By condoning an implicit waiver of Reading's regulatory right to arbitrate, we would erode investors' ability to use an efficient and cost-effective means of resolving allegations of misconduct in the brokerage industry and thus undermine FINRA's ability to regulate, oversee, and remedy any such misconduct."

The 3rd Circuit acknowledged its split with the 9th Circuit in City of Reno v. Goldman Sachs and with the 2nd Circuit in Goldman Sachs v. Golden Empire Schools. The appellate panels in those cases held that contractual forum selection clauses superseded FINRA's mandatory arbitration rule. But the 3rd Circuit panel said it agreed with the 4th Circuit's 2013 ruling in UBS v. Carilion Clinic, which concluded that forum selection clauses must specifically mention waiver of the right to FINRA arbitration in order to trump the arbitration default.

"In so holding," the 3rd Circuit said in the Reading decision, "we split with some of our sister circuits, but begin the process of closing this contractual loophole to FINRA's compulsory arbitration rule."

Like all of the previous appellate rulings on FINRA arbitration and forum selection clauses, the Reading case involved auction-rate securities, instruments once popular for their supposed liquidity but later revealed to be artificially propped up by the

banks that underwrote them. The Reading Health System issued four rounds of ARS, raising $500 million over several years. JPMorgan served as the underwriter. Two of the underwriting contracts between Reading and JPMorgan contained provisions that said all actions arising from their agreement would be brought in Manhattan federal district court.

Nevertheless, after the ARS market collapsed, Reading filed a claim for FINRA arbitration in 2014. JPMorgan, citing the forum selection clause, refused to arbitrate. So Reading brought a declaratory judgment suit in federal court in Philadelphia, seeking to compel arbitration. JPMorgan moved to transfer the case to Manhattan, the contractually designated forum.

U.S. District Judge **Lawrence Stengel** of Philadelphia sided with Reading, finding first that the declaratory judgment case did not have to be transferred to Manhattan because it did not actually arise from the agreement between Reading and the underwriter or the ARS offerings, but rather from Reading's right to arbitrate under FINRA rules. (I know, this is quite a lawyerly parsing but the 3rd Circuit justifies it quite elegantly in Tuesday's opinion.) Judge Stengel went on to conclude that the forum selection clause did not override Reading's arbitration rights.

The 3rd Circuit agreed: If JPMorgan wanted Reading to waive its arbitration rights, the appeals court said, then it should have spelled out the waiver. "We are reluctant to find an implied waiver here," the opinion said.

Typically, when you see a clear split among the federal circuits, you start to wonder about a potential request for U.S. Supreme Court review. JPMorgan counsel **Jonathan Youngwood** of **Simpson Thacher & Bartlett** not was available for comment. The ARS issuers in the Goldman cases at the 2nd and 9th Circuits do not seem, based on Westlaw, to have petitioned the Supreme Court to look at forum selection and FINRA arbitration, even though the rulings in their cases diverged from the earlier 4th Circuit decision.

Reading lawyer **Mark Strauss** of **Kirby McInerney** said in an email that the 3rd Circuit panel decision should be the end of the forum selection issue. There's no reason for the 3rd Circuit to rehear the case en banc, he said, because the unanimous decision was based on the appellate court's own 1987 precedent on implicit waiver in Patten Securities v. Diamond. As for the Supreme Court, Strauss said, the circuit split turned on an issue of contract interpretation - did the forum selection clause waive the brokerage customers' FINRA arbitration rights? - that probably wouldn't attract the justices' interest.

The juicier issue at play in these cases, Strauss said, is whether securities laws prohibit brokerages to abrogate customers' FINRA arbitration rights via forum selection clauses, even if those clauses contain an explicit waiver. The Public Investors Arbitration Bar Association argued in an amicus brief in the Reading case that brokerage customers' FINRA arbitration rights actually cannot be waived because they're not mere contractual rights.

"That arguably would be a significant question worthy of Supreme Court review," Strauss said, "but the appellate decisions haven't squarely ruled on it because either (it) wasn't raised (e.g., Golden Empire) or, as in this case, the question wasn't necessary to resolve."

(NOTE: This story has been updated to include a comment from Reading's lawyer, Mark Strauss.)