82311-1

IN THE SUPREME COURT
OF THE STATE OF WASHINGTON

MICHAEL BROOM, KEVIN BROOM and ANDREA BROOM

Respondents

v.

MORGAN STANLEY DW INCORPORATED and KIMBERLY ANNE BLINDHEIM. Petitioners

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AMICUS BRIEF
OF THE
PUBLIC INVESTORS ARBITRATION BAR ASSOCIAION

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I. Identity and Interest of Amicus

PIABA is a national, non-profit, voluntary, public bar association established in 1990, with a membership of approximately 450 attorneys located in 44 states and Puerto Rico. To qualify for membership, attorneys must devote a significant portion of their practice to representing public investors in securities arbitrations. PIABA members have represented tens of thousands of investors in securities arbitrations around the country. PIABA's mission is

> to promote the interests of the public investor in securities and commodities arbitration by protecting public investors from abuses in the arbitration process, . . . ; making securities and commodities arbitration as just and fair as systematically possible; and creating a level playing field for the public investor in securities and commodities arbitration.

The United States Supreme Court, between 1987–1989, reversed longstanding precedent and held that that contracts providing for the arbitration of federal securities claims were enforceable[1]. Since that time, virtually every broker-dealer in America has required customers to sign a broad mandatory arbitration clause whenever opening a brokerage account. Except in rare circumstances, all such claims must be submitted

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[1] *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 109 S.Ct. 1917, 104 L. Ed. 2d 526 (1987); *Rodriguez v. Shearson/American Express, Inc.*, 490 U.S. 477, 109 S.Ct. 1917, 104 L. Ed. 2d 526 (1989).

to the arbitration forum established and operated by the Financial Industry Regulatory Authority (FINRA)[2].

The present case involves FINRA's Code of Arbitration Procedure. PIABA asks for leave to provide the Court with additional perspectives from the viewpoint of attorneys and their clients who must operate within the FINRA arbitration system, who have no personal stake in the immediate controversy, but who may be greatly affected by the impact of the Court's ruling on the securities arbitration system nationwide.

II. Statement of the case.

PIABA accepts the Statement of Facts in the Court of Appeals, unpublished decision below.

III. Argument.

The Court of Appeals correctly held that (1) former NASD Code of Arbitration Procedure Rule 10304 cannot reasonably be read to authorize arbitrators to apply substantive claim statutes of limitations which "by their express terms" do not apply to arbitration proceedings,[3] (2) under Washington case law statutes of limitations governing

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[2] FINRA was created in July 2007 through the consolidation of the National Association of Securities Dealers and the member regulation, enforcement and arbitration functions of the New York Stock Exchange.

[3] Citing one of the primary authors of this Brief, Joseph C. Long, "Re-Thinking the Application of Statutes of Limitations in Arbitration," 2 PIABA Bar Journal 14, 28 (Summer 2007).

substantive claims are not "applicable" in arbitrations, and (3) Washington courts could vacate an arbitration award under "the error of law" rule, as the arbitrators exceeded their powers in applying the substantive statute of limitations.[4]

A. Regulatory History Makes Clear that Former NASD Rule 10304 Did Not Authorize Arbitrators to Apply Statutes of Limitations.

The Court of Appeals noted that the subsequent history of Rule 10304 indicates it simply meant that FINRA's six-year eligibility rule for submitting a matter to arbitration did not extend "'applicable statutes of limitation' in *court actions*" (italics by the Court). Opinion, ¶ 23. In fact, the entire history of Rule 10304 makes this clear. On October 15, 2003 the NASD submitted a wholly reorganized and restated set of Arbitration Rules to the SEC for approval,[5] proposing, among other things, to restate the language of Rule 10304 as follows:

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[4] The issue whether the FAA or the WAA controls will not be addressed because the Court of Appeals found this issue to have been waived, and the parties do not appear to further argue that point before this Court. The better reasoned cases on this point, in any event, hold that the WAA should control. *See Trombetta v. Raymond James Fin. Serv., Inc.*, 2006 Pa. Super 229, 907 A.2d 550 (2006); *SWAB Fin. v. E*Trade Sec.*, 150 Cal. App.4th 1181, 58 Cal. Rptr. 3d 904 (Cal. App. 2007); *Strausbaugh v. H & R Block Fin. Advisors, Inc.*, 2007 WL 3122257 (Ky App. Oct. 26, 2007).

[5] 70 FR 36442 (Jun. 23, 2005), "Notice of Filing of Proposed Rule Change and Amendment Nos. 1, 2, 3, and 4 Thereto to Amend NASD Arbitration Rules for Customer Disputes," SEC Rel. No. 51856 (Jun. 15, 2005).

Existing: **Rule 10304. Time Limitations Upon Submission**	**New:** **12206. Time Limits [Proposed]**
(a) No dispute, claim, or controversy shall be eligible for submission to arbitration under this Code where six (6) years have elapsed from the occurrence or event giving rise to the act or dispute. . . .	*(a) Time Limitation on Submission of Claims* No claim shall be eligible for submission to arbitration under this Code where 6 years have elapsed from the occurrence or event giving rise to the claim. The panel will resolve any questions regarding the eligibility of a claim under this Rule.
(b) Dismissal of a claim under this Rule does not prohibit a party from pursuing the claim in court. . . .	*(b) Dismissal under Rule* Dismissal of a claim under this Rule does not prohibit a party from pursuing the claim in court. . . .
(c) This Rule shall not extend applicable statutes of limitations; nor shall the six-year time limit. . . apply to any claim that is directed to arbitration by a court. . . .	(c) Effect of Rule on ***Time Limits for Filing Claim in Court*** The Rule does not extend applicable statutes of limitations. However, where permitted by applicable law, when a claimant files a statement of claim in arbitration, any time limits for the filing of the claim in court will be tolled while NASD retains jurisdiction of the claim. (Emphasis added.)

The SEC publishes notices of proposed new rules and invites public comment. Proposed Rule 12206 remained unchanged from 2003 through the intervening years of comments and amendments. The NASD on May 4, 2006 submitted to the SEC "Proposed Amendment 5 to SEC

file SR-2003-158,"[6] discussing and analyzing the comments it had received. In response to a comment on proposed Rule 12206, the NASD explained that "Proposed Rule 12206 *is substantively the same as Rule 10304* of the current Code" (emphasis added):

> One commenter suggests that the current six-year eligibility rule [contained in Rule 10304] should be eliminated, and instead the proposed rules *should authorize* the arbitration panel to apply, to the extent applicable, relevant statutes of limitations. *NASD notes that Proposed Rule 12206 is substantively the same as Rule 10304* of the current Code; hence, the comments made on this issue are outside the scope of the rule filing. (Emphases added.)[7]

In restated Rule 12206 the reference to "extending applicable statutes of limitations" unambiguously refers to the "effect of the Rule on time limits for filing claims *in court.*" According to the NASD's report to the SEC, the language in existing Rule 10304 meant exactly the same thing. Significantly, the NASD's comments did not question the commenter's premise that Rule 10304, as it was then written, did not authorize NASD arbitrators to apply statutes of limitations.

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[6] File SR-2003-158 was the NASD's 2003 proposal for amending and restating the Rules of Arbitration Procedure.

[7] Amendment No. 5 to Proposed Rule Change, NASD File No. SR-NASD-2003-158, available at www.finra.org,. Discussed in SEC Rel. No. Release No. 34–55158, 72 Fed. Reg. 4574 (January 31, 2007), at 4581.

B. The NASD's Executives and Members of the Securities Industry Have Long Understood that Securities Arbitrators Are Not Authorized to Apply Substantive Claim Statutes of Limitations

The NASD and securities industry participants have themselves represented that under the arbitration rules statutes of limitations are not applicable in securities arbitrations.

In September 1994 the NASD formed a task force to study NASD arbitration policy, chaired by former SEC Chairman David S. Ruder. The Task Force after two years of study issued a report, "National Association of Securities Dealers, Inc., Securities Arbitration Reform" (1996) (commonly known as the "Ruder Report"). Among other things, the Ruder Report recommended that the NASD replace the six year eligibility rule with a procedure to apply statutes of limitations, on a trial basis:

> The eligibility rule initially was adopted to serve the same purposes as a statute of limitations, that is, to eliminate stale claims. . . . [S]ix years was the period selected to conform to many of the SEC's record retention requirements for broker-dealers. . . .
>
> The Task Force recommends that the NASD suspend the eligibility rule for a three year period and *replace* it with procedures to resolve dispositive motions on *statute of limitations* grounds. . . . If . . . the *new* procedures for resolving statute of limitations matters are successful in eliminating many time barred claims from arbitration, then the six year eligibility rule should be rescinded permanently. (Emphases added; footnotes omitted.)

That recommendation went nowhere, but what is significant is the Ruder Commission's understanding that the six year eligibility rule was the sole time limitation on filing NASD arbitration claims, and that "new procedures" would have to be adopted in order for arbitrators to apply statutes of limitations.

Linda Feinberg, then NASD Dispute Resolution President, explained in a 2004 presentation to State securities regulators that the equitable nature of arbitrations and consequent absence of legal technicalities obstructing customer claims benefitted customers, and was one of the desirable features of arbitration.[8]

In testimony before Congress[9], Marc E. Lackritz, president of the Securities Industry Association (now Securities Industry and Financial Markets Association[10]), testified that the securities industry arbitration system is "fair to customers" because as an equitable proceeding it allowed customers to avoid "technical, procedural" obstacles such as

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[8] Remarks of Linda Feinberg, "First NASAA Listens Forum on Arbitration," Nation Press Club, Washington, D.C., Tuesday, July 20, 2004, reprinted as Appendix N, Seth E. Lipner and Joseph C. Long, *Securities Arbitration Desk Reference* (2009-2010 ed.).

[9] House Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, March 17, 2005 hearing on "A Review of the Securities Arbitration System".

[10] The Securities Industry Association subsequently merged with The Bond Market Association to form SIFMA, the Securities Industry and Financial Markets Association. *See* http://www.investinginbonds.com/story.asp?id=410.

statute of limitations defenses. Just six months before the Brooms filed their NASD claim, Mr. Lackritz was assuring Congress:

> [C]laimants in arbitration are not held to technical pleading standards. . . . The more streamlined process of arbitration, as compared with the many procedural . . . obstacles that must be overcome by a plaintiff in a court case, means that nearly every case brought in arbitration . . . goes to a full merits hearing. . . .
>
> This is in sharp contrast to court proceedings, where a significant percentage of claims are dismissed . . . on what may be described as technical, or procedural, grounds. This includes dismissals for pleading failures, jurisdictional failures, and *statute of limitations bars*. . . . (Emphasis added.)

SIFMA filed an *amicus* brief in this case supporting Morgan Stanley's Petition for Review. Despite its position before Congress that the absence of statutes of limitations in securities arbitrations made it fair in part because its rules do not apply statutes of limitations to bar customer claims, SIFMA now takes the opposite position before this Court:

> In contrast to the facts in *Thorgaard*, where there was in fact a sound reason to eliminate an unnecessary procedural hurdle. . . , the elimination of time defenses in arbitration will impose a further burden on the arbitration system and its participants.

This is typical of the securities industry's hypocrisy: it sold mandatory arbitration to Congress and the courts as an efficient, equitable proceeding, free from technicalities that bedevil the judicial system, while at the same it seeks to persuade arbitrators to use those exact technicalities to defeat

customer's legitimate claims.

C. Washington Courts Have the Authority to Vacate an Arbitration Award Based Upon an Error of Law Apparent Upon the Face of the Award

The Court of Appeals recognized and discussed the long history of Washington courts vacating arbitration awards for "errors of law apparent on the face of the award". While the specific statutory basis for using the words "error of law" was removed from the Washington Arbitration Act many years ago, Amicus submits that the "error of law" concept was carried forward in Section 7.04.160(4) of the WAA which allows vacatur based upon arbitrators exceeding their authority. "Error of law" is merely a way of saying that the arbitrators exceeded their authority. A number of cases, both by this Court and the Washington Courts of Appeals, appear to have recognized RCW 7.04.160(4) as the modern statutory basis for the "error of law" doctrine. *See e.g., Boyd v. Davis*, 127 Wn.2d. 256, 897 P.2d 1239 (1995).

Amicus Associated General Contractors urges the Court to adopt a standard that would tolerate serious legal errors by arbitrators in favor of finality, urging that ""[m]istakes of judgment and mistakes of either fact or law are among the contingencies parties assume when they submit disputes to arbitration." Amicus would respectfully suggest that, unlike

construction industry actors, the retirees and other individual investors represented by PIABA's members do not understand they are assuming the risk that the law will be disregarded, when they sign an application to open a brokerage account containing a mandatory arbitration clause.

Securities arbitrations involve special considerations that make some comparisons with other arbitration systems inapposite. Historically arbitration developed in purely contractual settings, such as in labor-management relations or international commercial disputes, dealing with the interpretation and enforcement of contract obligations. Securities arbitrations, on the other hand, generally involve special *statutory* rights created for the American public under federal and state securities laws.

Despite passage of the Federal Arbitration Act in 1952, the U.S. Supreme Court long held that agreements to arbitrate statutory securities claims were invalid, because such cases involved special investor protections investors which could not be waived and could be adequately protected only by "the exercise of judicial direction". *Wilco v. Swan,* 346 U.S. 427, 435-436, 74 S. Ct. 182, 98 L. Ed. 168 (1953). While the U.S. Supreme Court overruled *Wilco* many years later in *Shearson/American Express, Inc. v. McMahon, supra,* it reiterated *Wilco's* premise[11] that

[11] In *Wilko, supra* 346 U.S. at 433 the majority stated:

> [I]n so far as the award in arbitration may be affected by

arbitrators are obliged to follow the securities laws. The main reason given in *McMahon* for the Supreme Court's change of heart was its belief that the securities arbitration system had evolved, and did provide sufficient judicial review to ensure that arbitrators applied the law:

> [T]here is no reason to assume at the outset that arbitrators will not follow the law; although judicial scrutiny of arbitration awards necessarily is limited, such review is sufficient to ensure that arbitrators comply with the requirements of the statute.

482 U.S. at 232.

Mandatory arbitration clauses in brokerage firm agreements are valid only because the courts are presumed to have the practical ability to control arbitrators who do not apply the law. The only means to control arbitrator misconduct is for the courts to refuse to confirm, or to vacate, an arbitration award. The *McMahon* Court recognized that under the FAA courts have the power to vacate on this basis, but did not indicate under what part of § 10 of the FAA this power was drawn from. Generally, the lower federal courts exercised this power on the non-statutory theory of "manifest disregard of the law". While the U.S. Supreme Court in *Hall Street Assoc., L.L.C. v. Mattel, Inc.*, 552 U.S. 576, 128 S.Ct. 1396 (2008),

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> legal requirements, statutes or common law, rather than by considerations of fairness, the provisions of the Securities Act control. This is true even though this proposed agreement has no requirement that the arbitrators follow the law.

questioned whether there could be non-statutory grounds for vacatur, the Ninth Circuit in *Bosack v. Soward*, 586 F.3d 1096 (9th Cir. 2009) responded that "Arbitrators exceed their powers when they express a "manifest disregard of law," which is a statutory ground for vacatur under both Section 10(a)(4) of the FAA. *In re Arbitration of Bosack v. Soward*, ___F.3d ___, 2009 U.S. App. LEXIS 23656, 9 (9th Cir. Oct. 26, 2009).

The Court of Appeals' decision below that the Washington courts have the power to vacate an arbitration award for errors of law was correct and is consistent with the most recent federal jurisprudence

D. FINRA Arbitrations Are Particularly Unsuited for Applying Statutes of Limitations.

FINRA arbitrations involve the kinds of claims that would be subject to the discovery rule if statutes of limitations applied—e.g., misrepresentations and omissions, breach of fiduciary duty, negligence, failure to supervise.[12] Washington's Securities Act expressly adopts the discovery rule for claims under the Act. RCW 21.20.430. So in FINRA arbitrations particularly, allowing statute of limitations defenses would

[12] According to FINRA's statistics for 2009, as of November, the most common claims asserted in FINRA arbitrations are, in order of frequency: misrepresentation and omissions to disclose (5,421); breach of fiduciary duty (3,917); negligence (3,152); breach of contract (2,596); failure to supervise (a form a negligence, 2,456); and unsuitability (2,294; under Washington law, a negligence action. *See Ives v. Ramsden*, 142 Wn.App. 369, 390-91, 174 P.3d 1231 (2008)).

invariably embroil the arbitrators in arguments over the discovery rule. Determining when a claim accrues or whether a statute of limitations should be tolled requires a fact-intensive inquiry by the arbitrators. FINRA's arbitration rules do not permit the sort of discovery necessary to develop those facts or dig for evidence. Depositions are rarely permitted and as a practical matter are unavailable in the usual case. Code of Arbitration Procedure, Rule 12510. Interrogatories are not permitted, and written requests for information are "generally limited to identification of individuals, entities, and time periods related to the dispute," without requiring "narrative answers or fact finding." Code of Arbitration Procedure, Rule 12507. While the parties are supposed to produce relevant documents, without the power to submit interrogatories or conduct depositions, claimants are unable to challenge defendants' assurances that "no such documents exist", and "we've given you everything relevant."

No legal background is necessary to be a FINRA arbitrator.[13] FINRA's rules require in customer/industry cases that one arbitrator on

[13] *See* FINRA web site, at http://www.finra.org/ArbitrationMediation/Neutrals/BecomeAnArbitrator/ArbitratorApplicationKit/

each 3-person panel be from the securities industry.[14] So arbitration panels vary wildly in their legal knowledge and ability to apply legal concepts like statutes of limitations and the discovery rule, which are defined and explained through case law.

FINRA allows non-lawyers to represent parties in arbitrations.[15] FINRA's web site invites public customers to submit arbitration claims online *pro se*. Claimants in FINRA arbitrations often will be ill-prepared to defend motions to dismiss on statute of limitations, or to raise and prove the applicability of the discovery rule.

E. There is No Reason to Change Washington Law on the Applicability of Statutes of Limitations for Substantive Claims In Arbitration.

Affirming the Court of Appeals' will not cause any change in securities arbitration—much less "eviscerate the reasonable expectations of parties to arbitration agreements that they could defend claims based on statutes of limitation" (Petitioners' Supplemental Brief, at 15). Securities

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[14] A pilot program is underway in which a limited number of cases are being processed without the requirement that there be an industry representative on the panel.

[15] Frequently Asked Questions, at http://finra.atgnow.com/finra/categoryBrowse.do:

> "A party may be represented by a non-attorney, unless state law prohibits such representation, the person is currently suspended or barred from the securities industry in any capacity, or the person is currently suspended from the practice of law or disbarred."

firms cannot possibly have such an "expectation" when this has long been the rule not only in Washington, but in most if not all jurisdictions with statutes of limitations applying to "actions" or "suits".[16]

While this Court can simply reaffirm the current law in Washington that statutes of limitations do not apply in arbitrations, it can also limit its ruling to FINRA arbitrations, given FINRA's unique rules and the special role that statutory claims play in such cases.

IV. Conclusion.

The securities industry forces public customers to arbitrate all claims in an industry-run forum. A member of the securities industry sits on every panel. Customers' ability to dig for information from recalcitrant or untruthful brokers or brokerage firms is severely circumscribed. Customers have no right to a jury. They have no right to appeal—and even the best decision makers occasionally make serious errors. The securities industry justifies all of this by insisting that procedural safeguards aren't necessary because arbitrations are equitable proceedings, the procedures are flexible, and the public is not at risk of losing their claims as the result of rigid litigation rules and technical legal defenses.

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[16] In addition to the authority Respondent Brooms cite (Supplemental Brief of Respondents Broom, at fn. 4), *see also Annot. Statute of Limitations As Bar to Arbitration Under Agreement*, 94 A.L.R.3d 533 (1979); *Morgan v. Carillon Inv., Inc.*, 2005 WL 5533924 (Ariz. Super., Maricopa County, Sept. 13, 2005) (case specifically involving securities arbitration; held that arbitrators manifestly disregarded the law by applying substantive claim statutes of limitations).

But then, once safely in the arbitration forum, the securities industry seeks to exploit every expensive, technical, procedural device it can to avoid ever having to the address the merits of investors' claims.

Washington's rule that statutes of limitations do not generally apply in arbitrations is especially appropriate for FINRA arbitrations. The Court should affirm the Court of Appeals' very reasoned opinion.

Dated December 29, 2009

Joseph C. Long by Carl J. Carlson per authority

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CERTIFICATE OF SERVICE

I hereby certify under penalty of perjury under the laws of the State of Washington that on the 29th day of December 2009, I caused a true and correct copy of the foregoing document to be placed in the United States mail, postage prepaid, to the following:

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