BETTER MARKETS

– FACT SHEET –

Make a Bad Arbitration System Even Worse for Investors Or Protect Their Right to Assert Claims for a Broker's Rule Violations? The Fourth Circuit Will Hear Argument on May 29, 2020

On May 29, 2020, the United States Court of Appeals for the Fourth Circuit will hear oral argument in a case that will determine whether injured investors can recover in arbitration for a broker's violation of the industry's own rule book. The answer would seem to be an obvious "yes," especially when a broker's arbitration agreement broadly requires "***any*** controversy, dispute, claim, or grievance" to be resolved in arbitration. But a federal district court thought otherwise, holding that violations of the rules governing brokers cannot serve as the basis for an arbitration claim: *Interactive Brokers LLC v. Saroop*, No. 3:17-cv-127, 2018 WL 6683047 (E.D. Va. Dec. 19, 2018). The court thus threw out an award in favor of investors and set a precedent that threatens to make an already unfair arbitration system even worse. The investors appealed the case, and Better Markets filed an *amicus curiae* (or "Friend of the Court") brief in support of the investors, arguing that the district court erred on both legal and policy grounds.

The case. Brokers who execute securities trades for their clients are subject to securities laws and regulations as well as a detailed set of rules written by an association of brokers known as the Financial Industry Regulatory Authority ("FINRA"). FINRA, a self-regulatory organization or SRO has compiled a rule book that leaves a lot to be desired but nevertheless creates an important set of guardrails against broker misconduct.

In this case, three individual investors (Saroop) suffered $500,000 in losses after their broker ("Interactive") allowed risky call options to be traded through a portfolio margin account in violation of FINRA rules intended to protect investors from high-risk trading practices. Saroop won an arbitration award for damages and attorneys' fees, but Interactive asked a federal court to vacate the award. The district court agreed, holding that the arbitrators based their award on violations of a FINRA rule; that the law allows no private right of action to enforce such rules; and that the arbitrators therefore acted in "manifest disregard of the law." The investors appealed to the Fourth Circuit.

Our arguments. In our *amicus* brief, Better Markets argued that the district court committed two major legal errors and set a precedent that would make an already unfair arbitration system even worse by erecting technical barriers against investors seeking recovery for broker misconduct:

- **The court ignored the broad scope of the parties' arbitration agreement, which governed the arbitration.** Under the Federal Arbitration Act, it is for the parties to define in their arbitration agreement what claims, procedures, and remedies are permitted in the arbitration process. Here, as in many cases, the agreement clearly provided that any dispute of any kind was not only allowed, but required, to be resolved in arbitration. Moreover, the arbitration agreement incorporated FINRA's code of arbitration procedure by reference, as well as Connecticut's arbitration law, both of which define permissible arbitration claims in the broadest possible terms. Finally, violations of FINRA rules in fact routinely do serve as the basis for arbitration awards. FINRA itself has publicly explained that investors can base their arbitration claims on violations of FINRA rules, citing this flexibility as a virtue of the arbitration process. The district court thus erred in concluding that violations of FINRA rules cannot support an arbitration award, given the broad terms of the parties' agreement.

- **The court also misapplied the standard for judicial review of an arbitration award.** In vacating the arbitration award, the district court relied on its conclusion that the panel acted in "manifest disregard of the law" by basing liability on an SRO rule violation. But that standard of judicial review is narrow and requires that the law in question be absolutely clear and free from reasonable dispute. That test could not be met here, since the law is unclear. In fact, the law *allows* SRO rule violations to support arbitration awards where an arbitration agreement covers all types of claims. Moreover, even some federal courts recognize violations of SRO rules as the basis for civil claims. At the very least, these facts cast doubt on the district court's blanket assertion that SRO rules cannot be enforced in private actions. Accordingly, the court misapplied the "manifest disregard of the law" standard.
- **The decision will create further obstacles for investors already facing long odds of obtaining meaningful relief in arbitration**. Finally, Better Markets argued that the district court's decision will make life even harder for investors who are typically forced into arbitration by non-negotiable, fine-print agreements written by their brokers. Arbitration is widely regarded as a flawed dispute resolution process because it's designed and run by the brokerage industry with profound conflicts of interest; the awards usually fall well short of investors' damages; and the process is secretive, usually resulting in terse orders without much explanation. The district court's decision, unless reversed, will make matters even worse, setting technical legal traps surrounding the specific types of claims or injuries that may be addressed by the arbitration panel. Specifically:
    - The decision will substantially curtail the types of broker misconduct that arbitrators can address. In fact, FINRA's rules define a vast universe of broker conduct that can harm investors, yet under the district court's decision, those actions are out of bounds in arbitration, leaving investors without recourse for many unscrupulous or abusive acts by brokers.
    - The decision will also scale back some of the few virtues of arbitration—its informality, speed, and affordability. It will induce parties to approach arbitration like litigation, and it will undoubtedly encourage more court challenges. Judicial review of arbitration awards is supposed to be exceptionally narrow—"among the narrowest known to law." But if the district court's lax interpretation of "manifest disregard of the law" by an arbitration panel remains intact, then brokers who lose in arbitration will feel emboldened to seek reversal in court more often, a pattern that will further burden investors who can ill-afford the expense.

What's Next. Oral argument is set for May 29, 2020, before the Fourth Circuit in Richmond, Virginia. Better Markets will be paying close attention and looking forward to the Court's eventual ruling on the merits. We'll see if it's a win for investors or another strike against them.
