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## If It Quacks Like a Duck: The Financial Industry Regulatory Authority and Federal Jurisdiction

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# If It Quacks Like a Duck: The Financial Industry Regulatory Authority and Federal Jurisdiction

Lesesne Phillips\*

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\* J.D. Candidate May 2018, Washington and Lee University School of Law. I offer my sincere gratitude to the editorial board for their meticulous edits and to Professor Albert Carr for graciously serving as my faculty advisor, and Ashley Slisz for serving as my student advisor. Most importantly, I thank my parents for their constant love and support.

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### I. Introduction

In the world of finance, stock brokers facilitate transactions for clients every day.<sup>1</sup> Stock brokers help their clients make financial decisions, tailoring the client's investments to each individual client's abilities and overall objectives.<sup>2</sup> Investors trust their brokers to make educated investment decisions and provide advice in the investors' best interests.<sup>3</sup> Additionally, they give their brokers access to large amounts of money for investment, in some instances even trusting their brokers with their entire life savings.<sup>4</sup> Therefore, it comes as no surprise that brokers operate under the presence of authorities regulating their conduct. Like the American Bar Association for lawyers, organizations exist to hold brokers accountable in the securities industry.<sup>5</sup> One such entity is the Financial Industry Regulatory Authority (FINRA), an organization providing rules and regulations for brokers to follow.<sup>6</sup> FINRA is a not-for-profit organization specifically made to ensure

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1. See Eliot Norton, *A Simple Purchase and Sale Through a Stock Broker*, 8 HARV. L. REV. 435, 436 (1895) (stating that stock brokers act as agents for those who wish to invest in securities).

2. See Robert N. Rapp, *Rethinking Risky Investments for that Little Old Lady: A Realistic Role for Modern Portfolio Theory in Assessing Suitability Obligations of Stockbrokers*, 24 OHIO N.U. L. REV. 189, 190 (1998) ("The suitability rule requires a broker to make a customer-specific determination of suitability and tailor her recommendations to the customer's financial profile and investment objective.").

3. See Jeffrey M. Salas, *Retirement Adrift: Financial Elder Abuse*, 86 WIS. LAW., Mar. 2013, at 18, 19 (presenting a hypothetical situation in which a client entrusts his broker with his retirement funds).

4. See *id.* (noting that the hypothetical of a retired couple losing their retirement fund is a reality to many Americans).

5. See *infra* Part II (discussing the various authorities and legislative acts developed to provide oversight of the securities industry).

6. See Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. 151, 152 (2008) (identifying FINRA as a Self-Regulatory Organization).

fairness and honesty in the securities industry.<sup>7</sup> While FINRA is not a federal or state governmental organization, the Securities Exchange Act provides specific procedures FINRA must follow.<sup>8</sup> As this Note will demonstrate, the Securities and Exchange Commission's (SEC) oversight of FINRA leads some to believe that FINRA acts in a governmental capacity.<sup>9</sup> Furthermore, the implication of FINRA as a quasi-governmental entity<sup>10</sup> allows the argument for FINRA rules to constitute federal law, inherently allowing federal jurisdiction for violations of FINRA rules.<sup>11</sup>

A hypothetical situation provides clarity on the issue at hand. An older investor recently employed a new stockbroker to set up financial plans for retirement. The investor feels apprehensive about investing in the securities markets, but the broker assures the investor with the promise of investment advice suitable to the investor's specific goals of retirement. However, a year later the investor finds that the broker encouraged investment of a high-risk security with the investor's money. Now the investor lost the retirement savings in its entirety. While the investor considers disciplinary proceedings against the broker,<sup>12</sup> the investor hopes to get at least some of the retirement savings back. The investor will not find resolve in appealing directly to the SEC, but must submit the dispute to FINRA arbitration.<sup>13</sup> During arbitration,

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7. See *About FINRA*, FINRA, <http://www.finra.org/about> (last visited Sept. 27, 2017) (providing information on what FINRA does for investors and members of the Self-Regulatory Organization) (on file with the Washington and Lee Law Review).

8. See, e.g., 15 U.S.C. § 78s (2012) (requiring FINRA to register with the SEC as well as comply with the SEC rules under threat of sanctions).

9. See *infra* Parts II, III and accompanying text (analyzing the structure of the SEC in regards to FINRA).

10. See William A. Birdthistle & M. Todd Henderson, *Becoming a Fifth Branch*, 99 CORNELL L. REV. 1, 5 (2013) ("We describe several mechanisms that appear to be driving the 'self' out of financial SROs, rendering them ever more quasi-governmental in nature.").

11. See *infra* Part V and accompanying text (arguing for exclusive federal jurisdiction because FINRA rules should be considered federal law, exclusive federal jurisdiction conforms with precedent, and exclusive federal jurisdiction creates a uniform standard).

12. For the purposes of this Note, the issue regarding federal jurisdiction does not involve FINRA's disciplinary process. This Note is only concerned with FINRA's arbitration proceedings.

13. See Barbara Black, *Punishing Bad Brokers: Self-Regulation and FINRA Sanctions*, 8 BROOK. J. CORP. FIN. & COM. L. 23, 23 (2013) ("FINRA, and not the

however, the investor finds the FINRA arbitrators partial to the broker and brokerage firm. Specifically, the arbitrators disregard FINRA Rule 13505<sup>14</sup> by neglecting to force the broker or brokerage firm to cooperate in discovery.<sup>15</sup> After the proceedings, the investor finds the arbitration award grossly inadequate compared to the amount of money lost in the bad investments. The investor files for a vacatur of the FINRA arbitration award pursuant to the Federal Arbitration Act § 10a.<sup>16</sup> The key issue involves the FINRA arbitrators' violation of an internal FINRA rule. Before filing, the investor decides whether to bring the suit in federal or state court. While many different considerations go into a plaintiff's decision to file in state or federal court, some plaintiffs remain precluded from exercising federal jurisdiction in some federal circuits.<sup>17</sup> The Ninth Circuit U.S. Court of Appeals allows federal jurisdiction for violations of FINRA internal rules.<sup>18</sup> However, in the Third and Second Circuits, state court remains the only option for a plaintiff to file this claim deriving from a violation of an internal FINRA rule.<sup>19</sup>

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U.S. Securities and Exchange Commission (the SEC), is the regulator that primarily addresses her concerns, the first through its arbitration forum.”).

14. See FINRA Rule 13505 (“The parties must cooperate to the fullest extent practicable in the exchange of documents and information to expedite the arbitration.”).

15. For purposes of this Note, arbitrators violating FINRA internal rules provide a clear example of the issue. This situation creates a violation of an internal rule as well as a ground for appeal of an arbitration award. Furthermore, this takes the dispute out of the arbitration process and into a court of law.

16. See 9 U.S.C. § 10a (2012) (allowing vacatur of an arbitration award where the award was procured by corruption or fraud, partiality is found among the arbitrators, the arbitrators are guilty of misconduct, and the arbitrators exceeded their powers). Additionally, an arbitration award may be vacated due to manifest disregard of the law. See *Wilko v. Swan*, 346 U.S. 427, 434–35 (1953), *overruled on other grounds by* *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 484 (1989) (“[A] failure of the arbitrators to decide in accordance with the provisions of the Securities Act would ‘constitute grounds for vacating the award pursuant to section 10 of the Federal Arbitration Act.’”).

17. See, e.g., *Goldman v. Citigroup Glob. Mkts., Inc.*, 834 F.3d 242, 249–50 (3d Cir. 2016) (disallowing federal jurisdiction for violations of internal FINRA rules).

18. See generally *Sacks v. Dietrich*, 663 F.3d 1065 (9th Cir. 2011).

19. See *Goldman*, 834 F.3d at 242 (falling under the Third Circuit's jurisdiction); *Doscher v. Sea Port Grp. Sec., LLC*, 832 F.3d 372, 375 (2d Cir. 2016) (falling under the Second Circuit's jurisdiction).

FINRA provides enforcement mechanisms and a system for alternative dispute resolution.<sup>20</sup> When a broker violates one of the SEC's rules, the parties submit to compulsory arbitration facilitated by FINRA to resolve the dispute.<sup>21</sup> FINRA arbitration follows a simplistic format broken down into filing claims, arbitrator selection, prehearing conferences, discovery, the hearing, and the decision or awards.<sup>22</sup> FINRA arbitrators render binding decisions on the two parties, and FINRA fails to provide an internal appellate process.<sup>23</sup> While the arbitration process provides decisions for many disputes between brokers and investors,<sup>24</sup> it is not without error.<sup>25</sup> As a result, FINRA provides a list of limited circumstances in which members may bring an appeal to a court of law.<sup>26</sup> However, in situations when an arbitrator clearly disregards an internal FINRA rule,<sup>27</sup> the FINRA

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20. See Karmel, *supra* note 6, at 173 (“The arbitration facilities of the NYSE and the NASD will be combined in a separate entity as part of FINRA.”).

21. See *id.* at 172–73 (stating that members of Self-Regulatory Organizations have had to submit to compulsory arbitration since the Supreme Court allowed these contracts in 1987).

22. See *Arbitration Process*, FINRA, <http://www.finra.org/arbitration-and-mediation/arbitration-process> (last visited Sept. 27, 2017) (providing a brief overview of the arbitration process) (on file with the Washington and Lee Law Review).

23. See *Decision & Award*, FINRA, <http://www.finra.org/arbitration-and-mediation/decision-award> (last visited Sept. 27, 2017) (“However, under federal and state laws, there are limited grounds on which a court may hear a party's appeal on an award.”) (on file with the Washington and Lee Law Review).

24. See Richard Berry, *The Financial Industry Regulatory Authority's Dispute Resolution Activities*, SECURITIES ARBITRATION AND MEDIATION HOT TOPICS 2016 (New York City Bar Association), April 2016 (“The Financial Industry Regulatory Authority (FINRA) operates the largest securities dispute resolution forum in the world. FINRA annually administers between 4,000 and 8,500 arbitrations and numerous mediations.”).

25. See, e.g., *Royal All. Assocs., Inc. v. Liebhaber*, 206 Cal. Rptr. 3d 805, 819 (Cal. Ct. App. 2016) (affirming the lower court's decision to vacate the arbitration award due to the FINRA arbitrators substantially prejudicing one of the parties); *Mun. Workers Comp. Fund, Inc. v. Morgan Keegan & Co.*, 190 So. 3d 895, 925 (Ala. 2015) (requiring vacatur of a FINRA arbitration award due to the arbitrators' failure to disclose relationship with broker-dealer); *Citigroup Glob. Mkts., Inc. v. Berghorst*, No. 11–80250–CIV, 2012 WL 5989628, at \*5 (S.D. Fla. Jan. 20, 2012) (vacating the FINRA arbitration award due to evident partiality or corruption by the arbitrators).

26. See *Decision & Award*, *supra* note 23 (listing six separate situations where a party may appeal an arbitration award).

27. See *id.* (stating that this is known as Manifest Disregard of the Law).

regulations remain unclear as to whether these appeals should be brought in federal or state court.<sup>28</sup> If arbitrators disregard a clearly defined law applicable to the case before them,<sup>29</sup> where should the disadvantaged party bring the appeal? Are there benefits of bringing an appeal to a state court as opposed to a federal court, or are the federal courts a more appropriate forum to bring these appeals? As it stands, the federal circuit courts are split as to the appropriate jurisdiction for this key issue.<sup>30</sup> Fundamentally, the issue hinges on whether FINRA's internal rules qualify as federal law, or in the alternative that violations of FINRA internal rules raise a substantial federal issue qualifying for federal question jurisdiction.<sup>31</sup>

Analysis of the underlying jurisdictional question requires understanding of the relationship between FINRA and the SEC. In order to appreciate the nuances and importance of this relationship, one must also appreciate the historical context of Self-Regulatory Organizations (SRO) coinciding with the SEC, an independent federal agency.<sup>32</sup> Government oversight of SROs in the realm of finance developed over time through many promulgations and amendments to legislation, such as the

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28. See FINRA Rule 12904(b) ("Unless the applicable law directs otherwise, all awards rendered under the Code are final and are not subject to review or appeal."). However, the Federal Arbitration Act and specific state statutes constitute applicable law, and allow for vacatur of an arbitration award in very narrow circumstances. See 9 U.S.C. § 10(a) (2012) ("In any of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration."); see also, e.g., CAL. CIV. PROC. CODE § 1286.2(a) (West 2002) (giving six different reasons for vacatur of an arbitration award).

29. See, e.g., FINRA Rule 13505 ("The parties must cooperate to the fullest extent practicable in the exchange of documents and information to expedite the arbitration.").

30. See *infra* Part IV and accompanying text (analyzing the key issues involved in the circuit split).

31. Compare *Sacks v. Dietrich*, 663 F.3d 1065, 1069 (9th Cir. 2011) (stating that violations of internal FINRA rules warrant federal jurisdiction), with *Goldman v. Citigroup Glob. Mkts, Inc.*, 834 F.3d 242, 258 (3d Cir. 2016) (disputing a claim for federal jurisdiction of a violation of an internal FINRA rule).

32. See Jennifer M. Pacella, *If the Shoe of the SEC Doesn't Fit: Self-Regulatory Organizations and Absolute Immunity*, 58 WAYNE L. REV. 201, 202 (2012) ("Self-regulatory organizations (SROs) have consistently been deemed to 'stand in the shoes' of the Securities and Exchange Commission (SEC) by carrying out delegated, regulatory functions in interpreting and monitoring the securities laws.").

Securities Exchange Act of 1934.<sup>33</sup> Throughout the history of American securities, members of the profession evaluated the industry—often after market crashes<sup>34</sup>—and promoted change in pursuit of order and regularity.<sup>35</sup> Members trading in these markets met and established rules.<sup>36</sup> For example, the first meeting was the “Buttonwood Agreement,” where members met after a market crash in 1792 and agreed to deal among themselves.<sup>37</sup> Members of this group later reconvened in 1817 and created a constitution for the New York Stock and Exchange Board.<sup>38</sup> Eventually, the idea of self-regulation led to the formalization of SROs.<sup>39</sup>

Securities exchanges, commonly known as stock exchanges, provide an organized forum for buyers and sellers engaging in stock transactions.<sup>40</sup> SROs regulate the securities exchanges by disciplining errant members<sup>41</sup> and setting forth rules and

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33. See Karmel, *supra* note 6, at 151 (illustrating the merging of self-regulatory organizations).

34. See *id.* at 153 (“Congress and the SEC have struggled to convert SROs from ‘private clubs’ to public bodies, frequently exploiting scandals to impose governance reforms on exchanges and the NASD.”).

35. See generally Kenneth Durr & Robert Colby, *The Institution of Experience: Self-Regulatory Organizations in the Securities Industry, 1792-2010*, SEC HIST. SOC’Y (Dec. 1, 2010), <http://www.sechistorical.org/museum/galleries/sro/sro02b.php> (last visited Sept. 27, 2017) (beginning chronologically with the organization of members of the New York stock exchange in 1792) (on file with the Washington and Lee Law Review).

36. See *id.* (providing examples of these rules such as the structure for selling stocks, the delivery of the stocks, and discipline for members).

37. See *id.* (noting the legend and myth behind the agreement and providing articles arguing the verity of this legend).

38. See *id.* (stating that in 1817 members who originally signed the Buttonwood Agreement created the New York Stock and Exchange Board imposing initiation fees and admission standards).

39. See *id.* (changing the name from the New York Stock and Exchange Board to the New York Stock Exchange in 1863).

40. See Comment, *Over-the-Counter Trading and the Maloney Act*, 48 YALE L.J. 633, 635 (1939) (contrasting securities exchanges and over-the-counter markets).

41. See, e.g., *Birkelbach v. SEC*, 751 F.3d 472, 477–78 (7th Cir. 2014) (upholding a lifetime bar on a principal broker from participation in the securities industry rendered by FINRA due to failure of the principal to supervise an associate broker); *Cody v. SEC*, 693 F.3d 251, 253–54 (1st Cir. 2012) (finding the broker to have mismanaged accounts under his supervision and placing sanctions on the broker including suspension and fines); *Mathis v. SEC*, 671 F.3d 210, 214–



procedures for brokers and dealers to follow.<sup>42</sup> Today, SROs remain the primary source of protection for investors;<sup>43</sup> however, government oversight of the industry did not begin until 1934 under the Securities Exchange Act.<sup>44</sup> SROs evolved through three pieces of legislation, each of which will be discussed in further detail within this Note: the Securities Exchange Act of 1934,<sup>45</sup> the Maloney Act of 1938,<sup>46</sup> and the Exchange Act Amendments of 1975.<sup>47</sup>

This Note analyzes each Act to create a foundation of understanding for regulations within the securities realm,<sup>48</sup> and then examines the FINRA's role within that landscape.<sup>49</sup> An examination of the SEC's role in oversight accompanies this analysis.<sup>50</sup> Next, this Note will identify relevant case-law examining how courts previously treated SROs internal rules.<sup>51</sup> Following the treatment by the courts of prior SRO internal rules,<sup>52</sup> analysis will turn towards the federal circuit cases

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15 (2d Cir. 2012) (sanctioning an individual for failing to disclose tax liens filed against him by the Internal Revenue Service on his application for registry as a securities broker).

42. See Pacella, *supra* note 32, at 207 (listing the different functions of SROs).

43. See Christopher W. Cole, *Financial Industry Regulatory Authority (FINRA): Is the Consolidation of NASD and the Regulatory Arm of NYSE a Bull or a Bear for U.S. Capital Markets?*, 76 UMKC L. REV. 251, 252 (2007) (stating that securities laws at times preempt antitrust claims).

44. See Durr & Colby, *supra* note 35 (stating that the Securities Exchange Act of 1934 was a compromise between government regulation and SRO independence).

45. 15 U.S.C. § 78a *et seq.* (2000).

46. Over-the-Counter Market Act, 52 Stat. 1070 (1938).

47. Pub. L. No. 94-29, 89 Stat. 97 (1975).

48. See *infra* Part II and accompanying text (examining the Securities Exchange Act of 1934, the Maloney Act, and the Exchange Act Amendments of 1975).

49. See *infra* Part III.A and accompanying text (showing the importance of FINRA's role in the securities industry today).

50. See *infra* Part III and accompanying text (identifying the SEC's extensive control over FINRA).

51. See *infra* Parts C, D and accompanying text (examining prior case-law involving the New York Stock Exchange and the National Association of Securities Dealers).

52. See *infra* Part C and accompanying text (distinguishing between alleged claims involving violations of the securities laws which prompted federal jurisdiction and claims of alleged violations of SRO internal rules which did not

currently in dispute on the issue of characterization of FINRA internal rules and the underlying question of jurisdiction.<sup>53</sup> Finally, this Note will offer a solution to the question of appropriate jurisdiction for the characterization of FINRA internal rules.<sup>54</sup> Currently, the Supreme Court's decision in *Merrell Lynch, Pierce, Fenner & Smith Inc. v. Manning*<sup>55</sup> leaves the question of exclusive federal jurisdiction open to interpretation in regards to violations of internal FINRA rules. This allows plaintiffs to formulate claims without mention of federal law in order to place disputes in state court.<sup>56</sup>

## II. *The Securities and Exchange Commission and Self-Regulation*

### A. *The Securities Exchange Act of 1934*

The lasting effects of the Great Depression sparked governmental regulation under President Roosevelt's New Deal administration.<sup>57</sup> The New Deal provided a time of government oversight from which the securities industry was not exempt.<sup>58</sup> Before the New Deal, brokers remained under limited supervision from the Federal Government,<sup>59</sup> but many felt protection for

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necessarily prompt federal jurisdiction).

53. See *infra* Part IV and accompanying text (identifying the circuit split in the Second, Third, and Ninth circuits).

54. See *infra* Part V and accompanying text (arguing for federal jurisdiction for violations of internal FINRA rules).

55. 136 S.Ct. 1562 (2016).

56. See Case Comment, *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Manning*, 130 HARV. L. REV. 417, 425 (2016) (noting the ability for clever plaintiffs to avoid federal jurisdiction).

57. See Richard B. Stewart, *Evaluating the New Deal*, 22 HARV. J. L. & PUB. POLY 239, 240 (1998) (“[T]he New Deal firmly established the proposition that the federal government ought to take responsibility for the overall productivity and health of the economy at the macro-economic level.”).

58. See A. C. Pritchard & Robert B. Thompson, *Securities Law and the New Deal Justices*, 95 VA. L. REV. 841, 846–47 (2009) (providing examples of New Deal legislation including the Securities Act of 1933 that provided for governmental regulation of public offerings and most notably the Securities Exchange Act of 1934, which regulated trading practices and established the Securities and Exchange Commission).

59. See John Hanna, *The Securities and Exchange Act of 1934*, 23 CAL. L. REV. 1, 1 (1934) (stating that the U.S. government took a *laissez-faire* stance

investors was necessary after the collapse in the Stock Market.<sup>60</sup> In response to this perceived need, the Securities Exchange Act of 1934 established the SEC.<sup>61</sup> The Act imposed integrated regulation on the securities industry,<sup>62</sup> and left some troubled by the slight break from *laissez-faire* economics of the past.<sup>63</sup> Furthermore, the Act fomented oversight of the self-regulatory system, encompassing regulations for the stock exchanges such as the New York Stock Exchange (NYSE).<sup>64</sup> Mandatory regulations included the requirement of the individual stock exchanges to register with the SEC,<sup>65</sup> registration of securities on the national stock exchanges,<sup>66</sup> and oversight of the national stock exchanges by the SEC.<sup>67</sup> Due to the regulations placed on SROs by the SEC, scholars argue that SROs act as governmental entities in some capacity.<sup>68</sup> Specifically, William A. Birdthistle and M. Todd Henderson argue that “mechanisms of governmentalization”<sup>69</sup> lead to increased

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before promulgation of the Securities Exchange Act of 1934).

60. See Durr & Colby, *supra* note 35 (stating that after the Great Depression, those in the Roosevelt Administration were convinced that the securities industry required government oversight).

61. 15 U.S.C. § 78a *et seq.* (2000).

62. See Hanna, *supra* note 59, at 1 (“[I]ntegrated industry is one which digs its own raw material out of its own land, transports it by its own carriers, manufactures it through many stages into finished products, moves the products to its own selling depots, and disposes of the output through its own selling organization.”).

63. See *id.* (regarding the Exchange Act of 1934 as a complete integration of the “manufacturing” involved in the securities industry).

64. See Durr & Colby, *supra* note 35 (positing that the Exchange Act of 1934 created a self-regulatory model).

65. See Hanna, *supra* note 59, at 16 (noting the New York Stock Exchange and all the other major exchanges already registered under the Securities and Exchange Commission at the time).

66. See *id.* at 19 (outlining the requirements for registration of securities under Sections 12 and 13 of the Securities Exchange Act of 1934).

67. See *id.* at 20 (requiring a national stock exchange to certify the security wishing to register on the market and allowing the SEC to refuse registration).

68. See Karmel, *supra* note 6, at 159–71 (noting the structure and governance of FINRA under the SEC and the fact that FINRA is solely accountable to the SEC as arguments that FINRA acts as a governmental agency); Jerrod M. Lukacs, *Much Ado About Nothing: How the Securities SRO State Actor Circuit Split Has Been Misinterpreted and What It Means for Due Process at FINRA*, 47 GA. L. REV. 923, 928 (2013) (outlining the arguments and recent circuit split considering FINRA as a state actor and a governmental agent).

69. See Birdthistle & Henderson, *supra* note 10, at 26–51 (identifying eight

governmental regulation of SROs,<sup>70</sup> and could lead to complete governmental control of these entities.<sup>71</sup> In fact, one author theorized that due to the wide authority given to FINRA by the SEC, FINRA has the qualities of a federal government agency.<sup>72</sup> If SROs act as federal governmental entities, then there is a strong argument for violations of SRO internal rules warranting federal jurisdiction.

### *B. The Maloney Act of 1938*

While the Securities Exchange Act of 1934 provided oversight for SROs of the securities exchanges, a distinct lack of government regulation for over-the-counter brokers and dealers remained.<sup>73</sup> Over-the-counter brokers and dealers facilitate purchases and sales that do not take place on one of the national securities exchanges.<sup>74</sup> Authorities in 1938 argued that the generality of the Securities Exchange Act of 1934 required further legislation due to the failure of regulation for the over-the-counter trade market.<sup>75</sup>

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different mechanisms for governmentalization of SROs including, for example, the type of entities regulated, the increasing size of losses, and changes in industry structure).

70. *See id.* at 24 (“Over the past few decades, some financial SROs appear to have lost much of the ‘self’ in self-regulatory organization, and that element of independence has been replaced with a more governmental approach. We call the process by which this is happening the ‘governmentalization’ of SROs.”)

71. *See id.* (“Whether they fully appreciate it or not, financial SROs are transforming into a ‘fifth branch’ of government.”). The authors give alternative solutions to this push towards SROs becoming the “fifth branch” of government by, for example, discontinuing the process of SRO rule promulgation. *See id.* at 64. The authors, however, also acknowledge that discontinuing the process requires strong political support which seems unlikely. *See id.*

72. *See* Karmel, *supra* note 6, at 152 (concluding that classifying FINRA as a governmental agency is premature).

73. *See* Durr & Colby, *supra* note 35 (“Whereas the Exchange Act had created a new self-regulatory model that enveloped the NYSE and the regional exchanges into a scheme of federal securities regulation, the Maloney Act extended that model to entities other than exchanges.”)

74. *See* William Taft Lesh, *Federal Regulation of Over-the-Counter Brokers and Dealers in Securities*, 59 HARV. L. REV. 1237, 1237 (1946) (outlining the substantive law for regulation of over-the-counter brokers).

75. *See* Comment, *supra* note 40, at 634 (“The Maloney Act is the result of some four years of research and study by both the Commission and representatives of the over-the-counter industry.” (citing Chester T. Lane,

Then in 1938, Congress passed the Maloney Act to amend the Securities Exchange Act of 1934.<sup>76</sup> The Act sought to make over-the-counter dealers regulate their own activities with government supervision.<sup>77</sup> Specifically, the Act created two provisions: the first provision called for the creation of voluntary self-regulatory organizations to establish rules and regulations with the power to sanction errant behavior;<sup>78</sup> the second provision gave the SEC the power of oversight of the over-the-counter market.<sup>79</sup> The Maloney Act integrated the purpose of SROs, common in today's securities industry, to cover over-the-counter market trading.<sup>80</sup> These amendments led to the registration of the National Association of Securities Dealers (NASD).<sup>81</sup> At first, NASD was a self-regulatory organization without a stock exchange.<sup>82</sup> The SEC later required membership in NASD for all broker-dealers registered by the SEC.<sup>83</sup> However, in 1971, NASD created the National Association of Securities Dealers Automated Quotation system (NASDAQ), which was an electronic securities market.<sup>84</sup> Eventually, NASD merged with the regulatory branch of

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Address before the Investment Bankers' Association of America at San Francisco, California, S.E.C. Release (Mar. 11, 1938)).

76. See generally Tamar Hed-Hofmann, *The Maloney Act Experiment*, 6 B.C. INDUS. & COM. L. REV. 187 (1965) (championing the success of the NASD to register as a regulatory association).

77. See *id.* at 187 (allowing associations of broker-dealers to register under the SEC).

78. See *supra* note 41 and accompanying text (providing different examples of SROs disciplining errant members).

79. See Comment, *supra* note 40, at 634 (identifying the importance of individuals in the over-the-counter market industry to conform to the Maloney Act).

80. See Pacella, *supra* note 32, at 207 ("The exchanges and non-exchanges that are regulated by the Exchange Act are known today as SROs, with some of the most common examples being FINRA, NASDAQ, NASD, NYSE, the Chicago Stock Exchange, and the International Securities Exchange.")

81. See *id.* (stating that NASD was the only association to register in lieu of the Maloney Act Amendments).

82. See Karmel, *supra* note 6, at 160–63 (stating that the NASD originally was a voluntary organization to regulate over-the-counter market trading separate of securities exchange).

83. See *id.* at 153 (noting this requirement of membership began in 1983).

84. See *id.* at 161 ("Today, Nasdaq is completely separated from the NASD, is a public company, and is recognized by the SEC as a stock exchange.").

the NYSE to create FINRA in 2007.<sup>85</sup> Through this merging, the securities industry gained a single set of regulations which members must follow through FINRA.<sup>86</sup> The standardization of securities industry regulations and the oversight of these regulations by the SEC promote the idea of exclusive federal jurisdiction for violations of FINRA rules.

### C. The Exchange Act Amendments of 1975

The next prominent piece of legislation changing the relationship between the SEC and SROs was the Exchange Act Amendments of 1975.<sup>87</sup> These amendments addressed the financial crisis occurring from 1968 to 1971.<sup>88</sup> The 1975 Amendments required SROs to submit proposed rule changes to the SEC for notice and comment rulemaking.<sup>89</sup> While these amendments promoted the impact of SROs on the securities industry, they also created sweeping oversight of these bodies.<sup>90</sup> Those in favor of a *laissez-faire* economic plan fundamentally

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85. Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified as amended at 15 U.S.C. § 78(a)-(kk) (2012)).

86. See Birdthistle & Henderson, *supra* note 10, at 23 (“According to NASD, additional benefits were to ‘streamline the broker-dealer regulatory system, combine technologies, and permit the establishment of a single set of rules and a single set of examiners with complementary areas of expertise within a single SRO.’” (citing Order Approving Proposed Rule Change Related to Consolidation of Regulatory Functions of NASD and NYSE, 72 Fed. Reg. 42,188 (Aug. 1, 2007))).

87. See Karmel, *supra* note 6, at 159–60 (“In 1975, the Exchange Act was amended and the SEC obtained greater authority to regulate and supervise the NYSE, other exchanges and the NASD.”).

88. See Phillip A. Loomis, Jr., Comm’r, SEC, Address at the Joint Securities Conference 1975: The Securities Acts Amendments of 1975, Self-Regulation and the National Market System (Nov. 18, 1975) (stating that the Commission received an unexpected high volume in trades and then the stock prices crashed causing the financial crisis from 1968 to 1971).

89. See Andreas M. Fleckner, *Stock Exchanges at the Crossroads*, 74 *FORDHAM L. REV.* 2541, 2554 (2006) (noting two major aspects of the legislation including further oversight by the SEC and creating the National Market System).

90. See Karmel, *supra* note 6, at 162 (“However, this Act strengthened the SEC’s oversight role by, among other things, giving the SEC the power to initiate as well as approve SRO rule-making, expanding the SEC’s role in SRO enforcement and discipline, and allowing the SEC to play an active role in structuring the trading markets.”).

objected to the idea of further regulation, but the SEC found it necessary to implement these amendments after the economic crisis.<sup>91</sup>

Today, the Securities Exchange Act provides specific procedures for SROs to follow when changing their internal rules.<sup>92</sup> First, an SRO must file a copy of the proposed rule, the proposed rule change, or a rule deletion to the SEC.<sup>93</sup> Additionally, the SRO must provide a concise general statement of basis and purpose of the rule change.<sup>94</sup> After filing the proposed rule change with the SEC, the SEC will publish notice of the rule change and provide the issues involved or any terms of substance.<sup>95</sup> The SEC then gives interested persons time for meaningful comment through written data, views, and arguments.<sup>96</sup> SRO rule changes do not become law unless authorized by the SEC.<sup>97</sup> Additionally, the SEC may create rules for individual SROs following a similar procedure, but without the influence from the individual SRO.<sup>98</sup> Overall, the breadth of oversight by the SEC provides a substantial federal influence on SRO's internal rules. Violations of these SRO rules, with immense oversight from the SEC, prompts arguments for federal jurisdiction.

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91. *See* Loomis, *supra* note 88 (noting the fact that Congressional Committees conducted research on the securities markets).

92. 15 U.S.C. § 78s(b) (2012).

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.*

97. *See id.* (“No proposed rule change shall take effect unless approved by the Commission or otherwise permitted in accordance with the provisions of this subsection.”).

98. *See id.* § 78s(c) (“The Commission, by rule, may abrogate, add to, and delete from (hereinafter in this subsection collectively referred to as ‘amend’) the rules of a self-regulatory organization.”).

### III. Background

#### A. The Financial Industry Regulatory Authority (FINRA)

FINRA originated in 2007<sup>99</sup> through the merging of the NASD and the NYSE's regulatory body.<sup>100</sup> Unlike other SROs of the past, however, FINRA fails to serve a commercial purpose because it lacks a stock exchange.<sup>101</sup> Instead, the SEC instituted FINRA to create a monopoly on SROs.<sup>102</sup>

In addition to its regulatory and enforcement functions, FINRA provides many different services to investors.<sup>103</sup> These services include: access to brokers' conduct history;<sup>104</sup> access to prior arbitration awards,<sup>105</sup> FINRA market data,<sup>106</sup> and

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99. See *supra* note 85 and accompanying text (citing the statute that merged the National Association of Securities Dealers and the regulatory arm of the New York Stock Exchange).

100. See Karmel, *supra* note 6, at 152 ("The stated purpose for the consolidation of the NASD and NYSE's regulatory arm is to bring more efficiency to securities industry regulatory efforts by creating a single rule book for broker-dealers.").

101. See *id.* (concluding that FINRA should not be classified as a government agency despite its investigative and disciplinary functions).

102. See *id.* at 153–54 ("[T]he monopoly status of FINRA strengthens its role as a regulator of broker-dealers.").

103. See *Tools & Calculators*, FINRA, <http://www.finra.org/investors/tools> (last visited Sept. 27, 2017) (providing multiple tools which investors can use through the FINRA website) (on file with the Washington and Lee Law Review).

104. See *FINRA Broker Check*, FINRA, <https://brokercheck.finra.org/> (last visited Sept. 27, 2017) (allowing an investor or any member of the public to search a broker or firm in their area, providing conduct history and licensing information about the broker) (on file with the Washington and Lee Law Review).

105. See *Arbitration Awards*, FINRA, <http://www.finra.org/arbitration-and-mediation/arbitration-awards> (last visited Sept. 27, 2017) (allowing members of the public to research past arbitration awards rendered by FINRA and NASD free of charge) (on file with the Washington and Lee Law Review).

106. See *Market Data*, FINRA, <http://finra-markets.morningstar.com/MarketData/Default.jsp> (last visited Sept. 27, 2017) (providing members of the public with market and investment research to assist investors) (on file with the Washington and Lee Law Review).



preventative data<sup>107</sup> helping minimize investor vulnerability to fraud.<sup>108</sup>

Imperative to FINRA's regulatory authority is FINRA's arbitration process.<sup>109</sup> Because investors victimized by their brokers cannot seek relief directly from the SEC,<sup>110</sup> investors bring the dispute to FINRA arbitration.<sup>111</sup> FINRA provides options for investors to arbitrate or the parties can both agree to mediate during or before the arbitration process.<sup>112</sup> Additionally, investors may file investor complaints, which are separate claims for when investors believe a specific broker is violating FINRA regulations.<sup>113</sup> Internal rules of a SRO refer to the rules that the SRO makes and apply to members of the SROs.<sup>114</sup> Specifically, FINRA retains its own internal rules for members to follow.<sup>115</sup> In

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107. See *Risk Meter*, FINRA, <http://apps.finra.org/meters/1/riskmeter.aspx> (last visited Sept. 27, 2017) (allowing potential investors to take a test to determine whether they are at risk for investment fraud) (on file with the Washington and Lee Law Review).

108. See *Tools & Calculators*, *supra* note 103 (providing hyperlinks to specific investor services).

109. See *generally Arbitration and Mediation*, FINRA, <http://www.finra.org/arbitration-and-mediation/overview> (last visited Sept. 27, 2017) (on file with the Washington and Lee Law Review).

110. See FINRA Rule 13200 ("Except as otherwise provided in the Code, a dispute must be arbitrated under the Code if the dispute arises out of the business activities of a member or an associated person and is between or among: members; members and associated persons; or associated persons.").

111. See Jill I. Gross, *The Customer's Non-waivable Right to Choose Arbitration in the Securities Industry*, 10 BROOK. J. CORP. FIN. & COM. L. 383, 384 (2016) ("To prevent investors from having a unilateral right to demand arbitration, virtually all brokerage firms include provisions in their form contracts with retail customers requiring arbitration of customers' disputes in an SRO forum, primarily FINRA's Office of Dispute Resolution.").

112. See *Arbitration and Mediation*, FINRA, <http://www.finra.org/arbitration-and-mediation/overview> (last visited Sept. 27, 2017) (providing an overview of the arbitration and mediation process) (on file with the Washington and Lee Law Review).

113. See *id.* (explaining that filing a claim for arbitration or mediation to a monetary dispute differs from an investor complaint in that an investor complaint makes FINRA aware of any activity of a broker that may be fraudulent). For purposes of this Note, analysis primarily relies on the arbitration process.

114. See 69 AM. JUR. 2d *Securities Regulation-Federal* § 319 (2017) ("These internal regulations now supplement the requirements of the Exchange Act and form a large part of the overall regulation of securities transactions on exchanges for the protection of investors.").

115. See *Rules and Guidance*, FINRA, <http://www.finra.org/industry/rules->

the context of violations of internal FINRA rules, an arbitrator's "clear manifest disregard" for the rules provides a clear example of the issue at hand.<sup>116</sup> Because limited circumstances exist for vacatur of an arbitration award,<sup>117</sup> this Note focuses on the violation of FINRA internal rules by the arbitrator. The main analysis will focus on FINRA's internal rules and whether a violation of one of those rules constitutes a violation of federal law prompting federal question jurisdiction.<sup>118</sup> Analysis will include the difficulties presented by each side of the argument for state jurisdiction and federal jurisdiction.<sup>119</sup> Additionally, the arguments will be supplemented by prior case-law involving other SROs.<sup>120</sup> As this Note will demonstrate, violations of internal FINRA rules deserve exclusive federal jurisdiction due to the structure of FINRA, its relation to the SEC, and prior case-law.

### *B. Federal Question Jurisdiction*

To understand the arguments for FINRA internal rules falling under either federal jurisdiction or state jurisdiction, one must examine the statute granting federal jurisdiction. 28 U.S.C. § 1331

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and-guidance (last visited Sept. 27, 2017) ("As part of its mandate to protect investors and promote market integrity, FINRA enacts rules and publishes guidance in its role as regulator of securities firms and brokers.") (on file with the Washington and Lee Law Review).

116. See *Doscher v. Sea Port Grp. Sec., LLC*, 832 F.3d 372, 375 (2d Cir. 2016) ("As explained in *Greenberg*, federal-question jurisdiction lies on the face of the petition where 'the petitioner complains principally and in good faith that the award was rendered in manifest disregard of federal law.'" (citing *Greenberg v. Bear, Stearns & Co.*, 220 F.3d 22, 27 (2d Cir. 2000))).

117. See 9 U.S.C. § 10a (2012) (allowing vacatur of an arbitration award where the arbitrators are guilty of misconduct). Additionally, an arbitration award may be vacated due to manifest disregard of the law. See *Wilko v. Swan*, 346 U.S. 427 (1953), *overruled on other grounds by Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 484 (1989) ("In unrestricted submission, such as the present margin agreements envisage, the interpretations of the law by the arbitrators in contrast to manifest disregard are not subject, in the federal courts, to judicial review for error in interpretation.").

118. See *infra* Parts IV–V and accompanying text (examining current case-law on the issue).

119. See *infra* Part IV and accompanying text (demonstrating the struggles between the circuits in implementing a bright-line rule).

120. See *infra* Part III.C and accompanying text (evaluating different courts' decisions regarding violations of NYSE and NASD internal rules).

provides that “[t]he district courts shall have original jurisdiction of all civil actions arising under the Constitution, laws, or treaties of the United States.”<sup>121</sup> Courts often begin analysis with this statute when examining disputes regarding violations of internal FINRA rules constituting federal law.<sup>122</sup> However, the main statute providing jurisdiction for violations of SRO rules resides in the Securities Exchange Act.<sup>123</sup> The Securities Exchange Act provides a grant of *exclusive* federal jurisdiction.<sup>124</sup> The relevant statute is 15 U.S.C. § 78aa as amended, with courts often referring to the statute as § 27 of the Securities Exchange Act.<sup>125</sup> The statute provides that the district courts shall have “exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder.”<sup>126</sup> Exclusive federal jurisdiction requires that a state court evaluate the claims at hand and determine whether federal jurisdiction is appropriate.<sup>127</sup> Due to the nature of SRO rule promulgation, including the need for SEC approval, these statutes present an ambiguity regarding whether violations of SRO internal rules warrant federal jurisdiction or require resolution in state court.<sup>128</sup> Additionally, recent cases failed to provide a precise decision on the issue.<sup>129</sup> The holdings of *NASDAQ OMX Group, Inc.*

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121. 28 U.S.C. § 1331.

122. *See Doscher*, 832 F.3d at 377 (paralleling the arising under test for federal question jurisdiction to 15 U.S.C. § 78aa’s grant of exclusive federal jurisdiction).

123. *See* 15 U.S.C. § 78aa (2012) (“The district courts of the United States and the United States courts . . . shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder . . .”).

124. *Id.* (emphasis added) Exclusive federal jurisdiction requires that state courts evaluate the claims at hand to determine if federal jurisdiction is appropriate. *See* Case Comment, *supra* note 56, at 425–26 (“However, section 27 establishes exclusive federal jurisdiction, rather than concurrent federal jurisdiction as § 1331 does. As a result, it obliges state courts to undertake an additional line of inquiry to ensure that a cause of action does not fall under federal courts’ exclusive jurisdiction before proceeding.”).

125. *See, e.g., Merrell Lynch, Pierce, Fenner & Smith Inc. v. Manning*, 136 S.Ct. 1562, 1566 (2016) (“Section 27 of the Securities Exchange Act of 1934 (Exchange Act), 48 Stat. 992, as amended, 15 U.S.C. § 78a, *et seq.*”).

126. 15 U.S.C. § 78aa.

127. *See supra* note 56 and accompanying text (stating that this could lead to discrepancies among jurisdictions).

128. *See supra* notes 92–96 and accompanying text (identifying the specific procedures for notice and comment rulemaking under SEC oversight).

129. *See generally Manning*, 136 S. Ct. at 1568; *NASDAQ OMX Grp., Inc. v.*

*v. UBS Securities, LLC*<sup>130</sup> and *Manning* provide pertinent arguments to the issue at hand, but ultimately require clarification. Specifically, the *Manning* holding creates the current test for federal jurisdiction under 15 U.S.C. § 78aa.<sup>131</sup> Fundamentally, *Manning* requires analysis under § 78aa to mimic the “arising under” test found in 28 U.S.C. § 1331.<sup>132</sup> Yet application to the specific issue of violations of FINRA rules remains untested. Without clarification, the door remains open for plaintiffs to specifically word their claims in order to avoid federal jurisdiction.<sup>133</sup>

### *C. Self-Regulatory Organizations and Circuit Rulings Involving Organizations Other than FINRA*

Prior to the creation of FINRA, federal courts ran into problems regarding whether violations of other SRO internal rules required resolution in state or federal court.<sup>134</sup> Federal court of appeals cases in the Second and Ninth Circuits, for example, provide specific arguments for appropriate jurisdiction over SRO’s internal rules as state or federal law.<sup>135</sup> Often, these cases provide

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UBS Sec., LLC, 770 F.3d 1010 (2d Cir. 2014).

130. 770 F.3d 1010 (2d Cir. 2014).

131. See *Manning*, 136 S. Ct. at 1570 (“If (but only if) such a case meets the ‘arising under’ standard, [§ 78aa] commands that it go to federal court.”).

132. See *id.* (stating that despite the difference in language between the two statutes, the Court made the “arising under” test applicable to § 78aa as well).

133. See Case Comment, *supra* note 56, at 425 (stating that the *Manning* case provides an opportunity for plaintiffs to stay in state court through artful pleading); see also Dale & Harris, *Federal Jurisdiction Over State Securities Claims*, N.Y. L.J. ONLINE (June 10, 2016), <http://www.newyorklawjournal.com/id=1202759508231/Federal-Jurisdiction-Over-State-Securities-Claims> (last visited Sept. 27, 2017) (“Because of this uncertainty, a future plaintiff who wishes to stay in state court may play it safe by ‘purg[ing] his complaint of any references to federal securities law, so as to escape removal.’” (citing *Manning*, 136 S. Ct. at 1575)).

134. See, e.g., *Barbara v. N.Y. Stock Exch.*, 99 F.3d 49, 50 (2d Cir. 1996) (providing an example of a case involving the New York Stock Exchange before the creation of FINRA in 2007).

135. See *id.* at 55 (finding the plaintiff’s claims to be insufficiently substantial to “arise under” federal law within the meaning of 28 U.S.C. § 1331); *D’Alessio v. N.Y. Stock Exch.*, 258 F.3d 93, 99–104 (2d Cir. 2001) (distinguishing the case in *Barbara* due to the nature of the claim); see also *Sparta Surgical Corp. v. Nat’l Ass’n of Sec. Dealers, Inc.*, 159 F.3d 1209, 1212 (9th Cir. 1998) (dealing with

support recent disputes regarding jurisdiction over violations of FINRA's internal rules.<sup>136</sup> However, due to FINRA's unique structure as an SRO without a stock exchange, these arguments present no definitive answer.<sup>137</sup> The functions of the NYSE and NASD held bifurcated functions: providing marketplaces for their members and serving as regulators of the marketplace.<sup>138</sup> However, FINRA acts as a regulator over the entire securities industry.<sup>139</sup> Therefore, its impact on the securities industry as a whole differs from SROs of the past. Recent cases regarding FINRA jurisdiction contain arguments that an SRO, when acting as an organization, violating its own rules provides a more substantial impact on the securities industry as a whole.<sup>140</sup> FINRA's specific function as the sole regulatory entity of the securities industry, however, provides argument for its substantial impact on the system as a whole.<sup>141</sup> While the holding in *Manning* provides a different line of analysis for § 78aa, the following cases remain pertinent to differing views of substantiality that violations of internal SRO rules have on the securities industry.<sup>142</sup>

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NASD).

136. See *Sacks v. Dietrich* 663 F.3d 1065, 1069 (9th Cir. 2011) (relying on the decision in *Sparta Surgical* which found federal subject matter jurisdiction where the plaintiff's claim alleged violation of internal rules of NASD).

137. See *supra* note 101 and accompanying text (stating that FINRA differs from other SROs because it does not serve a commercial purpose).

138. See Karmel, *supra* note 6, at 153 (noting the practice of fixing commissions under the marketplace function and disciplining errant members as the regulatory function).

139. See Birdthistle & Henderson, *supra* note 10, at 42 (“[S]ubstantial SEC resources are spent on overseeing FINRA and its direct regulation of the securities industry.”).

140. See *Doscher v. Sea Port Grp. Sec., LLC*, 832 F.3d 372, 376 (2d Cir. 2016) (stating that a difference remains between claims involving an SRO breaching its own internal rules, such as the *UBS Securities* case, and claims like that of *Doscher*'s involving someone other than the SRO violating internal rules).

141. See Birdthistle & Henderson, *supra* note 10, at 23 (“The SEC Chairman, Christopher Cox, noted that the SEC ‘will work closely with FINRA to eliminate unnecessarily duplicative regulation, including consolidating and strengthening what until now have been two different member rulebooks and two different enforcement systems.’” (citing Press Release, SEC, SEC Gives Regulatory Approval for NASD and NYSE Consolidation (July 27, 2007), <http://www.sec.gov/news/press/2007/2007-151.htm> (last visited Sept. 27, 2017) (on file with the Washington and Lee Law Review))).

142. Compare *Sparta Surgical*, 159 F.3d at 1212 (noting the relationship between the SEC and NASD, specifically in relation to rule promulgation), *with*

Because the NYSE's regulatory arm merged with the NASD to create FINRA, NYSE cases provide helpful insight into arguments for both state jurisdiction of SRO's internal rules and arguments for federal jurisdiction of internal rules. The first pertinent case is *Barbara v. New York Stock Exchange*.<sup>143</sup> In *Barbara*, a former member of the NYSE claimed that the administrators of the disciplinary proceedings violated the internal rules of the NYSE.<sup>144</sup> Barbara initially brought his claim in state court, alleging multiple violations by the defendants including tortious interference with contractual relationships and breach of a covenant of fair dealing within an implied contract.<sup>145</sup> After the defendants removed the case to federal court, the district court dismissed the complaint and Barbara appealed to the Second Circuit.<sup>146</sup> While neither party raised the question of whether removal to federal court was proper, the Second Circuit ruled *sua sponte* on the issue.<sup>147</sup> First, the court stated that the complaint lacked a private right of action under 15 U.S.C. § 78f(d)<sup>148</sup> because the plaintiff was not an investor but a member regulated by the Exchange.<sup>149</sup> Additionally, the Second Circuit found the state courts to be a more suitable jurisdiction for Barbara because of the contractual nature of the claims.<sup>150</sup> Specifically, the court found

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*Merrell Lynch, Pierce, Fenner & Smith Inc. v. Manning*, 136 S. Ct. 1562, 1568–70 (2016) (concentrating analysis on the language of the federal statute as well as other federal statutes of similar language).

143. *Barbara v. N.Y. Stock Exch.*, 99 F.3d 49 (2d. Cir. 1996).

144. *See id.* at 51–53 (“Barbara alleged in his complaint that agents and officers of the Division had wrongfully barred him from the Exchange floor, thereby damaging Barbara’s reputation and causing him to lose employment opportunities with two Exchange members, and ultimately to leave the securities industry.”).

145. *See id.* at 52 (seeking \$10 million in compensatory damages and \$25 million in punitive damages).

146. *See id.* at 52–53 (dismissing the complaint due to the failure to exhaust administrative remedies).

147. *See id.* at 53 (explaining that the district court erred in hearing Barbara’s claims, but due to the circumstances of the case, the Second Circuit exercised jurisdiction).

148. *See* 15 U.S.C. § 78f(d) (2012) (requiring disciplinary action against members of a national securities exchange for failure to follow rules or regulations).

149. *See Barbara*, 99 F.3d at 54–55 (providing that investors fell under the class of people protected by that section).

150. *See id.* at 55 (finding the plaintiff’s claims to be insufficiently substantial

that “the rules of a securities exchange are contractual in nature.”<sup>151</sup> The court further noted that federal courts did not have any special expertise in the area of contracts.<sup>152</sup> Although this case fell under a dispute regarding the NYSE, the case retains relevance to arguments involving other SRO’s internal rules.<sup>153</sup> Because almost all contracts between brokerage firms and investors contain FINRA arbitration clauses,<sup>154</sup> parties in recent decisions argue that states remain the ideal jurisdiction for appeals regarding vacatur of FINRA arbitration awards.

However, the Second Circuit’s decision in *D’Alessio v. New York Stock Exch.*<sup>155</sup> distinguished *Barbara* by finding the specific nature of the claims to present a question in which federal jurisdiction was appropriate.<sup>156</sup> Specifically, the Second Circuit noted that D’Alessio claimed that the NYSE and its officers conspired to violate SEC laws as well as laws that the NYSE promulgated.<sup>157</sup> Unlike *Barbara*, in which the claims were solely based on the suitability of NYSE disciplinary proceedings, D’Alessio’s claims lacked any mention of disciplinary proceedings.<sup>158</sup> Ultimately, the judicial decision required interpretation of SEC laws as well as determination of the scope of the NYSE’s duties under the Securities Exchange Act as a SRO.<sup>159</sup>

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to “arise under” federal law within the meaning of 28 U.S.C. § 1331).

151. See *id.* at 54–55 (citing *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Geogiadis*, 903 F.2d 109, 113 (2d Cir. 1990)).

152. See *id.* at 55 (finding that *Barbara*’s complaint failed to arise under federal subject matter jurisdiction under 28 U.S.C. § 1331).

153. See *Sparta Surgical Corp. v. Nat’l Ass’n of Sec. Dealers, Inc.*, 159 F.3d 1209, 1213 (9th Cir. 1998) (using *Barbara* for arguments on immunity of a self-regulatory organization (citing *Barbara v. N.Y. Stock Exch.*, 99 F.3d 49, 58 (2d Cir.1996)).

154. See *Gross*, *supra* note 111, at 384 (noting that courts enforce these clauses strictly to their terms).

155. 258 F.3d 93 (2d Cir. 2001).

156. See *id.* at 101 (“We find the facts present in this case distinguishable from those in *Barbara*, and conclude that the instant suit implicates a federal interest sufficiently substantial to confer subject matter jurisdiction under section 1331.”).

157. See *id.* at 101–02 (finding D’Alessio’s claims to be rooted in federal law instead of state law).

158. See *id.* (demonstrating the need for allegations of violations of federal law in order for federal subject matter jurisdiction to be granted).

159. See *id.* (noting specifically that the alleged misconduct by the NYSE

The Second Circuit found D'Alessio's complaints based on the SEC laws and the interpretation of those laws by the NYSE raised a substantial federal question, and found federal jurisdiction appropriate.<sup>160</sup> While *D'Alessio* and *Barbara* involved interpretation of the disciplinary proceedings of SROs,<sup>161</sup> the arguments presented by each case provide helpful insight into the arguments for both sides of the issue regarding violations of FINRA internal rules.<sup>162</sup> Specifically, *D'Alessio* provided federal jurisdiction over an SRO interpreting a SEC law, as opposed to an SRO interpreting its own internal rules.<sup>163</sup>

NASD merged with the regulatory body of the NYSE to form FINRA.<sup>164</sup> One of the key cases involving federal jurisdiction was *Sparta Surgical Corp. v. National Association of Securities Dealers, Inc.*<sup>165</sup> In *Sparta Surgical*, NASD de-listed Sparta Surgical Corporation's public offering and suspended trading of the stock, effectively rendering the stock unmarketable.<sup>166</sup> Sparta Surgical's claim relied on NASD's violation of its own rules and regulations for listing and de-listing stocks.<sup>167</sup> The Ninth Circuit

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consisted of false interpretations of the federal laws involving D'Alessio's activities).

160. See *id.* at 102–03 (finding additionally that the NYSE's inability to fulfill its general oversight function qualified the case for federal jurisdiction).

161. The issue of disciplinary proceedings of SROs is not the central issue of this Note. However, *D'Alessio* provides an important distinction between an SRO interpreting an SEC rule, and an SRO interpreting its own internal rules.

162. See *Sacks v. Dietrich* 663 F.3d 1065, 1068 (9th Cir. 2011) (relying on the reasoning in *Sparta Surgical*); *Doscher v. Sea Port Grp. Sec., LLC*, 832 F.3d 372, 376 (2d Cir. 2016) (directly disputing the holding in *Sparta Surgical*).

163. See *D'Alessio*, 258 F.3d at 101 (“[A]n examination of the allegations contained in the complaint establishes that D'Alessio's suit is rooted in violations of federal law, which favors a finding that federal question jurisdiction exists.”).

164. See *NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority—FINRA*, FINRA (July 30, 2007), <http://www.finra.org/newsroom/2007/nasd-and-nyse-member-regulation-combine-form-financial-industry-regulatory-authority> (last visited Sept. 17, 2017) (announcing the merging of the NASD and the NYSE to form FINRA) (on file with the Washington and Lee Law Review).

165. *Sparta Surgical Corp. v. Nat'l Ass'n of Sec. Dealerts, Inc.*, 159 F.3d 1209 (9th Cir. 1998).

166. See *id.* at 1211 (suspending trading without explanation and resuming trading the next day).

167. See *id.* at 1212 (“Here, although Sparta's theories are posited as state law claims, they are founded on the defendants' conduct in suspending trading and de-listing the offering, the propriety of which must be exclusively determined



found federal jurisdiction appropriate due to the nature of the claim.<sup>168</sup> The court placed special emphasis on the fact that the NASD listing and de-listing rules “were issued pursuant to the Exchange Act’s directive that self-regulatory organizations adopt rules and by-laws in conformance with the Exchange Act.”<sup>169</sup> Specifically, the procedure that SROs must follow in order to promulgate, add to, or delete rules includes approval by the SEC.<sup>170</sup> Due to the relationship between the SRO and the SEC in the rule-making process, the court found the alleged violations of NASD rules requiring federal jurisdiction.<sup>171</sup> Federal Courts are granted exclusive jurisdiction under 15 U.S.C. § 78aa “over actions brought ‘to enforce any liability or duty’ created by exchange rules.”<sup>172</sup> Therefore, the Ninth Circuit found federal jurisdiction appropriate for alleged violations of NASD violating its own rules and regulations.<sup>173</sup> Alternatively, Sparta Surgical argued against federal jurisdiction, reasoning that there must be a private right of action for enforcement of a federal right.<sup>174</sup> Because there was no private cause of action for breaching SRO rules, Sparta Surgical believed federal jurisdiction was inappropriate.<sup>175</sup> However, the

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by federal law.”).

168. *See id.* at 1213 (finding federal subject matter jurisdiction existed at the time of removal).

169. *See id.* at 1212 (citing 15 U.S.C. § 78o-3(b) (2012)).

170. *See* 15 U.S.C. § 78s(c) (2012) (“The Commission, by rule, may abrogate, add to, and delete from . . . the rules of a self-regulatory organization . . . to insure the fair administration of the self-regulatory organization . . .”).

171. *See Sparta Surgical*, F.3d at 1212 (finding federal jurisdiction would have been established even if the complaint did not rely on violations of NASD’s own rules).

172. *See id.* (stating that despite Sparta Surgical’s attempt to articulate the claims in the form of state actions, federal jurisdiction applied).

173. *See id.* (stating that federal jurisdiction would not have been found if grounded solely on 28 U.S.C. § 1331). However, analysis of § 78aa has changed pursuant to the decision in *Manning*, requiring application of the “arising under” test. *See Merrell Lynch, Pierce, Fenner & Smith Inc. v. Manning*, 136 S. Ct. 1562, 1567 (2016) (“[W]e read [§ 78aa] as conferring exclusive federal jurisdiction of the same suits as ‘aris[e] under’ the Exchange Act pursuant to the general federal question statute.”).

174. *See Sparta Surgical Corp. v. Nat’l Ass’n of Sec. Dealers, Inc.*, 159 F.3d 1209, 1212 (9th Cir. 1998) (“Sparta contests this conclusion . . . for the proposition that federal question jurisdiction cannot lie absent a private right of action to enforce the federal right.”).

175. *See id.* (stating that Sparta Surgical’s argument would have retained

Ninth Circuit found this argument unpersuasive, stating that searching for a private cause of action invoked federal question jurisdiction under 28 U.S.C. § 1331.<sup>176</sup> Furthermore, the court held that the present case invoked 15 U.S.C. § 78aa “which vests exclusive jurisdiction over claims concerning duties created by exchange rules in the federal courts.”<sup>177</sup>

#### D. The Manning Decision

Recently, *Manning* abrogated *Barbara* and *Sparta Surgical*.<sup>178</sup> Importantly, *Manning* defined the scope of 15 U.S.C. § 78aa, the exclusive federal jurisdiction grant to claims enforcing any liability or duty created under the Securities Exchange Act.<sup>179</sup> The case did not involve SROs, but involved the SEC’s Regulation SHO<sup>180</sup> which regulates and investigates short sales on the market.<sup>181</sup> Greg Manning, an investor, filed a complaint against Merrill Lynch and other financial institutions for devaluing stocks that Manning held due to naked short sales allegedly committed by the financial institutions.<sup>182</sup> Manning originally brought the

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merit if federal jurisdiction solely depended on § 1331).

176. *Id.*

177. *Id.* However, as previously stated, the present test for federal jurisdiction under § 78aa is the “arising under” test.

178. *Manning*, 136 S. Ct. at 1562.

179. *See Id.* at 1566 (“We hold today that the jurisdictional test established by that provision is the same as the one used to decide if a case ‘arises under’ a federal law.”).

180. *See* 17 C.F.R. §§ 242.203–242.204 (2015) (“Regulation SHO, which became fully effective on January 3, 2005, sets forth the regulatory framework governing short sales.”).

181. *See* *Merrell Lynch, Pierce, Fenner & Smith Inc. v. Manning*, 136 S. Ct. 1562, 1566 (2016) (“The SEC regulates such short sales at the federal level: The Commission’s Regulation SHO, issued under the Exchange Act, prohibits short sellers from intentionally failing to deliver securities and thereby curbs market manipulation.”).

182. *See id.*

A typical short sale of a security is one made by a borrower, rather than an owner, of stock. In such a transaction, a person borrows stock from a broker, sells it to a buyer on the open market, and later purchases the same number of shares to return to the broker. The short seller’s hope is that the stock price will decline between the time he sells the borrowed shares and the time he buys replacements to pay back his loan. If that happens, the seller gets to pocket the difference (minus

claim in state court, but the financial institutions removed the case to federal court.<sup>183</sup> While the complaint alleged state court claims, Manning cited Regulation SHO.<sup>184</sup> Merrill Lynch's original claim for federal jurisdiction rested on two grounds:<sup>185</sup> general federal jurisdiction under 28 U.S.C. § 1331 and 15 U.S.C. § 78aa of the Securities Exchange Act.<sup>186</sup> After reversal by the Third Circuit Court of Appeals, remanding the case to state court, the Supreme Court accepted Merrill Lynch's writ of certiorari based on the circuit split involving *Barbara* and *Sparta Surgical*.<sup>187</sup> Additionally, Merrill Lynch sought the Supreme Court's review solely on the federal question jurisdiction claim under 15 U.S.C. § 78aa of the Securities Exchange Act.<sup>188</sup> The Supreme Court's opinion began by noting each party's interpretation of § 78aa.<sup>189</sup> Merrill Lynch provided an expansive interpretation of § 78aa, averring that if a plaintiff's complaint either explicitly or implicitly claims that a defendant breached an Exchange Act duty, then federal courts have exclusive jurisdiction over the matter.<sup>190</sup> The Court noted that this effectively granted federal jurisdiction to a plaintiff bringing only claims grounded in state law, allowing a

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associated transaction costs). In a "naked" short sale, by contrast, the seller has not borrowed (or otherwise obtained) the stock he puts on the market, and so never delivers the promised shares to the buyer.

183. *See id.* at 1567 ("Manning brought his complaint in New Jersey state court, but Merrill Lynch removed the case to Federal District Court.").

184. *See id.* at 1566 ("Manning chose not to bring any claims under federal securities laws or rules. His complaint, however, referred explicitly to Regulation SHO, both describing the purposes of that rule and cataloguing past accusations against Merrill Lynch for flouting its requirements.").

185. *See id.* at 1567 ("Merrill Lynch asserted federal jurisdiction on two grounds.").

186. *See id.* (noting that the District Court denied Manning's motion to remand the case to state court).

187. *See id.* at 1567 n.1 (citing *Barbara* as construing § 27 more narrowly and *Sparta Surgical* as a broad interpretation of § 27).

188. *See id.* ("Merrill Lynch sought this Court's review solely as to whether § 27 commits Manning's case to federal court.").

189. *See id.* at 1568–69 (interpreting Merrill Lynch's arguments for federal jurisdiction first and then framing Manning's arguments against federal jurisdiction).

190. *See id.* at 1568 ("Whenever (says Merrill Lynch) a plaintiff's complaint either explicitly or implicitly 'assert[s]' that 'the defendant breached an Exchange Act duty,' then the suit is 'brought to enforce' that duty and a federal court has exclusive jurisdiction.").

plaintiff to win on those claims without proving breach of an Exchange Act duty.<sup>191</sup>

The Court, however, found this interpretation too broad in scope.<sup>192</sup> Manning read the “brought to enforce” language of the Exchange Act as conferring jurisdiction only if the Exchange Act created the claim.<sup>193</sup> While the Court acknowledged that plaintiffs asserting a cause of action under the Exchange Act fall under federal jurisdiction, it reasoned that it is not the exclusive way to achieve it.<sup>194</sup> If a plaintiff’s claim, grounded in state law, depends on whether the defendant breached the Securities Exchange Act, then it is “brought to enforce” a duty created by the Exchange Act and federal jurisdiction is appropriate.<sup>195</sup>

Most importantly, the Court concluded that a case asserting § 78aa under the Exchange Act must meet the “arising under” standard of 28 U.S.C. § 1331.<sup>196</sup> Therefore, a party seeking federal jurisdiction under § 78aa with a state-law claim requires the claim to “necessarily raise a stated federal issue, actually disputed and substantial, which a federal forum may entertain without disturbing any congressionally approved balance” of federal and state power.<sup>197</sup> The Court affirmed the lower court’s decision rejecting Merrill Lynch’s claim for federal jurisdiction.<sup>198</sup> *Manning* represents the key to interpreting § 78aa of the Securities Exchange Act. The current circuit split regarding FINRA internal rules rests on this interpretation due to the disputed issue over whether violation of FINRA internal rules create a substantial

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191. *See id.* (noting arguments found in Merrill Lynch’s brief that the focus was not on what the court would have to decide).

192. *See id.* (“But a natural reading of § 27’s text does not extend so far.”).

193. *See id.* at 1569 (“On that view, everything depends on (as Justice Holmes famously said in another jurisdictional context) on which law ‘creates the cause of action.’”).

194. *See id.* (“But it is not the only way.”).

195. *See id.* (giving a hypothetical in which a state statute made violating the Exchange Act involving naked short selling illegal).

196. *See id.* at 1570 (“If (but only if) such a case meets the ‘arising under’ standard, § 27 commands that it go to federal court.”).

197. *See id.* (citing *Grable & Sons Metal Products, Inc. v. Darue Eng’g & Mfg.*, 545 U.S. 308, 314 (2005)).

198. *See id.* at 1575 (“And that means, under our decision today, that the District court also lacked jurisdiction under § 27.”).

federal issue warranting exclusive federal jurisdiction.<sup>199</sup> While the Supreme Court reiterated its interpretation of § 78aa,<sup>200</sup> some worry about the application of the “arising under” test.<sup>201</sup> Without further interpretation from the Supreme Court, § 78aa of the Securities Exchange Act’s “arising under” standard may open the door to clever plaintiffs drafting complaints without referral to any federal law to ensure state jurisdiction.<sup>202</sup>

The final case providing substance to the legal argument for federal jurisdiction involving FINRA internal rules is *UBS Securities*. *UBS Securities* involved a dispute arising from the initial public offering of Facebook, Inc.<sup>203</sup> NASDAQ faced technical difficulties which delayed trading by half an hour on the day that Facebook went public.<sup>204</sup> Due to these technical difficulties, some orders of the Facebook stock were not processed,<sup>205</sup> and some of the confirmation messages ordinarily given to investors when purchasing stock were not transmitted to the buyers creating

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199. See *Doscher v. Sea Port Grp. Sec., LLC*, 832 F.3d 372, 376 (2d Cir. 2016) (finding an arbitrator violating an SRO internal to fail the “arising under” test due to insubstantiality of the federal issue involved).

200. See *Manning*, 136 S.Ct. at 1572 (“In deciding that the state court could do so, we described § 27—not once, not twice, but three times—as conferring exclusive jurisdiction of suits ‘arising under’ the Exchange Act.”).

201. See *Dale & Harris*, *supra* note 133 (“It therefore remains unclear how much latitude a plaintiff has to discuss federal securities laws in a complaint before triggering federal jurisdiction under § 1331.”); see also Case Comment *supra* note 56, at 423

However, the Court’s narrow focus on jurisdictional requirements may perversely result in *more* unpredictability, both because its preservation of federalism shores up plaintiffs’ ability to avail themselves of diverse investor-friendly state statutes, and because encumbering state courts with federal question analysis creates an additional line of inquiry that may lead to divergent results.

202. See Case Comment, *supra* note 56, at 425 (“Instead, the Court’s decision to restore some adjudicative power to states, paired with the ingenuity of the plaintiffs’ bar, portends change for litigants in cases alleging any kind of securities fraud.”).

203. See *NASDAQ OMX Grp., Inc. v. UBS Sec., LLC*, 770 F.3d 1010, 1013 (2d Cir. 2014) (“On May 18, 2012, NASDAQ was scheduled to conduct the highly-anticipated Facebook IPO.”).

204. See *id.* at 1013–14 (“The initial Eastern Standard start time of 11:00 a.m. was delayed approximately one half hour, largely due to technical difficulties that NASDAQ encountered.”).

205. See *id.* at 1014 (“First, over 30,000 orders entered between 11:11:00 a.m. and 11:30:09 a.m. were not included in the completed IPO Cross.”).

uncertainty in actual acquisition of the stock.<sup>206</sup> Despite these problems, NASDAQ failed to stop the trading of Facebook stock.<sup>207</sup> After these incidents, the SEC placed sanctions on NASDAQ for its failure to follow its own rules approved by the SEC.<sup>208</sup> Due to the Services Agreement signed by both parties, UBS Securities brought state law actions in arbitration proceedings for breach of contract, indemnification, breach of implied duties of good faith and fair dealing, and gross negligence.<sup>209</sup> When UBS filed for arbitration, NASDAQ sought a preliminary injunction from arbitration in federal district court.<sup>210</sup> UBS timely filed a motion to dismiss NASDAQ's preliminary injunction.<sup>211</sup> The district court granted NASDAQ's preliminary injunction, and UBS appealed to the Second Circuit.<sup>212</sup>

First, the court reviewed UBS's claim that the district court abused its discretion by exercising jurisdiction over an action only raising state law claims without two diverse parties to the action.<sup>213</sup> The court analyzed federal subject matter jurisdiction under the "arising under" standard found in 28 U.S.C. § 1331.<sup>214</sup>

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206. *See id.* ("[C]ertain trade confirmation messages . . . were not transmitted, as a result of which some NASDAQ members . . . were not able to determine whether their orders had been included in the cross and, therefore did not know what position they held in Facebook securities." (quoting SEC Release No. 34-69655, 2013 WL 2326683, at \*8)).

207. *See id.* ("Despite suggestions that it halt trading in the Facebook IPO, NASDAQ did not do so.").

208. *See id.* at 1015 ("The SEC conducted an investigation into NASDAQ's handling of the Facebook IPO, which resulted in the agency sanctioning NASDAQ for violating the Exchange Act by not complying with its own SEC-approved rules.").

209. *See id.* at 1018-19 ("UBS's demand does not assert any claims created by federal law . . . . This, however, does not necessarily preclude the exercise of federal jurisdiction.").

210. *See id.* at 1017 ("In lieu of an answer to UBS's demand for arbitration, on April 4, 2013, NASDAQ filed this action in the Southern District of New York seeking declaratory and injunctive relief.").

211. *See id.* (noting UBS's prompt response).

212. *See id.* ("On June 18, 2013, the district court granted NASDAQ's motion for a preliminary injunction and denied UBS's cross-motion to dismiss. UBS timely filed this appeal.").

213. *See id.* at 1018 ("We review a district court's challenged determination of subject matter jurisdiction de novo.").

214. *See id.* at 1018 ("Where, as here, there is no diversity of citizenship between the parties, we look to whether the case 'aris[es] under the Constitution, laws, or treaties of the United States' to determine whether federal jurisdiction is

The court then interpreted the action in dispute under the four part test for federal question jurisdiction, providing that “federal jurisdiction over a state law claim will lie if a federal issue is: (1) necessarily raised, (2) actually disputed, (3) substantial, and (4) capable of resolution in federal court without disrupting the federal-state balance approved by Congress.”<sup>215</sup> In determining whether the UBS arbitration claim brought a necessarily raised and actually disputed federal issue, the court observed that all of UBS’s state law claims relied on one of NASDAQ’s fundamental duties. This federal duty required the NASDAQ to operate a fair and orderly market.<sup>216</sup> The court determined that this reliance on NASDAQ’s duty fell under federal law because the duty derived from the Securities Exchange Act.<sup>217</sup> The pertinent sections in the Exchange Act identified by the court comprised of: the duty to maintain a fair and orderly market,<sup>218</sup> the duty of SRO internal rules to “remove impediments to and perfect the mechanism of a free and open market and a national market system,”<sup>219</sup> and the exchange’s duty to comply with its own SEC-approved rules.<sup>220</sup> Overall, the state law claims rested on the duties of the SRO as mandated by the SEC.<sup>221</sup> The court reasoned that the disputed federal issue was substantial because NASDAQ’s violation of an Exchange Act duty to operate a fair and orderly market was important to the development of federal securities law as a whole.<sup>222</sup> In the present circuit split, parties disputing federal

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properly exercised.”).

215. *Id.* at 1020 (quoting *Grable & Sons Metal Prods., Inc. v. Darue Eng’g & Mfg.*, 545 U.S. 308, 313–14 (2005)). This is known as the “arising under” test and is now the standard for federal jurisdiction under § 78aa.

216. *See id.* at 1021 (“UBS’s arbitration demand makes plain that a singular duty underlies all four of its state law claims: NASDAQ’s duty to operate a fair and orderly market.”).

217. *See id.* at 1021 (stating that Congress specified that the fundamental goal of federal securities law was to operate fair markets).

218. 15 U.S.C. § 78k-1(a)(1)(C) (2012).

219. *Id.* § 78f(b)(5).

220. *Id.* § 78s(g)(1).

221. *See* *NASDAQ OMX Grp., Inc. v. UBS Sec., LLC*, 770 F.3d 1010, 1021 (2d Cir. 2014) (“In short, ‘it is the propriety of [NASDAQ’s] actions, as prescribed under federal law, that is at the heart of [UBS’s] allegations.’” (quoting *D’Alessio v. N.Y. Stock Exch.*, 258 F.3d 93, 103 (2d Cir. 2001))).

222. *See id.* at 1024 (“In reaching this conclusion, we begin with language in the Exchange Act stating Congress’s express finding that ‘[t]he securities markets

jurisdiction claim that an arbitrator violating an internal rule, feigns in comparison to the duty of an SRO to operate an orderly market.<sup>223</sup> However, due to FINRA arbitration's impact over the securities industry as a whole,<sup>224</sup> federal jurisdiction remains appropriate.

### *E. Issue Presented*

The current circuit split encompasses arguments from the above cases.<sup>225</sup> The Second Circuit argues that there is a fundamental difference between an SRO violating its own internal rules and a third party violating an SRO internal rule.<sup>226</sup> The former finds federal question jurisdiction appropriate, while the latter requires states to handle the issue. Additionally, the Second Circuit held that under *Manning*, violations of internal SRO rules are not granted exclusive jurisdiction under 15 U.S.C. § 78aa.<sup>227</sup> The Ninth Circuit fundamentally relied on *Sparta Surgical* and 15 U.S.C. § 78aa to provide exclusive federal jurisdiction for violations of FINRA internal rules.<sup>228</sup> Due to the recent and unknown implications of the *Manning* decision, the situation

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are an important national asset which must be preserved and strengthened.” (quoting 15 U.S.C. § 78k-1(a)(1)(A)).

223. See *Doscher v. Sea Port Grp. Sec., LLC*, 832 F.3d 372, 376 (2d Cir. 2016) (stating that SROs breaching their own internal rules violate § 78s(g)(1), while third parties breaching internal rules do not breach any federal obligation).

224. See *Berry*, *supra* note 24 and accompanying text (noting the large amount of arbitrations conducted annually).

225. See, e.g., *Sacks v. Dietrich*, 663 F.3d 1065, 1068 (9th Cir. 2011) (relying on the holding in *Sparta Surgical* (citing *Sparta Surgical Corp. v. Nat'l Ass'n of Sec. Dealers, Inc.*, 159 F.3d 1209, 1212 (9th Cir. 1998))).

226. See *Doscher*, 832 F.3d at 376 (finding an SRO's specific conduct to breach the Securities Exchange Act as shown in *UBS Securities*, but an entity other than an SRO violating an internal SRO rule does not involve adjudication of a federal duty).

227. See *id.* at 376–77 (“More importantly, however, whatever force existed in the Ninth Circuit's conclusion that any violation of internal SRO rules falls categorically within 15 U.S.C. § 78aa[] . . . it is no longer tenable following the Supreme Court's recent decision in *Merrill Lynch, Pierce, Fenner, & Smith, Inc. v. Manning*.”).

228. See *Sacks*, 663 F.3d at 1068 (framing the issue as whether the FINRA arbitrators exceeded their jurisdiction).



regarding violations of internal FINRA rules poses a substantial issue that requires resolution.

#### *IV. Problems Among the Circuits*

The three circuits in disagreement over the issue of FINRA internal rule violations are the Second,<sup>229</sup> Third,<sup>230</sup> and Ninth Circuits.<sup>231</sup> The Second and Third Circuit held that federal jurisdiction for violations of internal FINRA rules was inappropriate, while the Ninth Circuit found federal question jurisdiction on this issue proper. This Note will first analyze the Ninth Circuit's decision granting federal jurisdiction,<sup>232</sup> and then move on to analysis of the Second and Third Circuit decisions.<sup>233</sup>

##### *A. The Ninth Circuit*

*Sacks v. Dietrich*<sup>234</sup> presents the Ninth Circuit's decision regarding federal jurisdiction for violations of FINRA internal.<sup>235</sup> Richard Sacks, the plaintiff, signed a contract with Vincent Dang to represent Dang in an arbitration proceeding in front of FINRA.<sup>236</sup> However, the original respondents to the arbitration proceedings sought disqualification of Sacks due to FINRA Rule 13208.<sup>237</sup> FINRA Rule 13208, in pertinent part, provides qualifications for representatives of parties in an arbitration action.<sup>238</sup> Specifically, the rule allows representation by a person

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229. See generally *Doscher*, 832 F.3d at 372.

230. See generally *Goldman v. Citigroup Global Mkts., Inc.*, 834 F.3d 242 (3d Cir. 2016).

231. See generally *Sacks*, 663 F.3d at 1065.

232. See *infra* Part IV.A (analyzing the *Sacks* case).

233. See *infra* Parts IV.B–C (analyzing *Doscher* and *Goldman*, respectively).

234. 663 F.3d 1065 (9th Cir. 2011).

235. See *id.* at 1068 (“The district court correctly held that it had jurisdiction over the action.”).

236. See *id.* at 1066–67 (stating that Dang and Sacks each signed and submitted arbitration claim to FINRA).

237. See *id.* at 1067 (finding Sacks to have initially represented Dang during two telephone interviews before the respondents sought disqualification).

238. See FINRA Rule 13208 (“Parties may be represented in an arbitration by a person who is not an attorney.”).

other than a lawyer unless “the person is currently suspended or barred from the securities industry in any capacity.”<sup>239</sup> Richard Sacks was barred from the securities industry in the early 1990s.<sup>240</sup> The arbitration panel dismissed Sacks from the dispute, due to disqualification under Rule 13208.<sup>241</sup> Additionally, the panel found authority to dismiss him under Rule 13413.<sup>242</sup> Sacks filed a complaint against two of the FINRA arbitrators stating that they exceeded their authority under FINRA rules.<sup>243</sup> The arbitrators removed the case to the federal district court. After the district court determined it had jurisdiction, the court dismissed Sacks’ claims on other grounds.<sup>244</sup> Sacks then filed an appeal to the Ninth Circuit.<sup>245</sup>

While the Ninth Circuit admitted that Sacks’ claims asserted state law causes of action, the underlying issue turned on whether the arbitrators exceeded their jurisdiction under FINRA arbitration rules which afforded federal jurisdiction.<sup>246</sup> The court fundamentally relied on the holding in *Sparta Surgical*.<sup>247</sup> Most

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239. See FINRA Rule 13208(c) (stating three different disqualifications for representation by a person other than a lawyer).

240. See *Sacks v. Dietrich*, 663 F.3d 1065, 1067 (9th Cir. 2011) (“Sacks who is not an attorney, was barred from the securities industry in 1991.” (citing *Sacks v. SEC*, 648 F.3d 945, 948 (9th Cir. 2011))).

241. See *id.* at 1067–68 (stating that it was undisputed that Sacks was barred by the securities industry).

242. See *id.* at 1068 (“The panel based its authority to apply Rule 13208 on Rule 13413, which provides that a panel has the authority to interpret and determine the applicability of all provisions under the Code.” (citing FINRA Rule 13413)).

243. See *id.* (“Sacks alleged that by disqualifying him from representing Dang, the defendant arbitrators exceeded the scope of their authority under the Uniform Submission Agreement, FINRA rules, and California law.”) Misconduct of arbitrators presents another ground for vacating an arbitration award. See 9 U.S.C. § 10a (2012) (giving examples of arbitrator misconduct, such as refusing to postpone the hearing).

244. See *id.* (stating additionally that arbitral immunity barred the plaintiff’s claims).

245. See *id.* at 1066 (“Richard Sacks appeals from the dismissal of his claims against two arbitrators who disqualified him from representing a client. The district court concluded that the claims were barred by arbitral immunity.”).

246. See *id.* (finding the alleged wrongful conduct by the arbitrators to be the application of Rule 13208).

247. See *id.* at 1068 (“The district court’s order was consistent with our holding in *Sparta Surgical Corporation v. National Association of Securities Dealers, Inc.*”).

importantly, the court stated that “if the arbitrators were allowed to disqualify Sacks under FINRA’s rules, there would be no viable cause of action.”<sup>248</sup> Therefore, despite Sacks’ claims, which were grounded in state law causes of action, there would be no case if alleged FINRA violations were not involved.<sup>249</sup> Violations of FINRA internal rules fell under 15 U.S.C. § 78aa.<sup>250</sup> Ultimately the court found federal jurisdiction appropriate under the Securities Exchange Act’s exclusive grant of jurisdiction under § 78aa, in accordance with *Sparta Surgical*.<sup>251</sup> However, after the *Sacks* opinion, *Manning* abrogated *Sparta Surgical* in August of 2016.<sup>252</sup> *Manning* delivered a devastating blow to the line of reasoning followed in *Sacks*. However, the impact of the *Manning* decision remains unclear as to the application involving FINRA’s internal rules because a dispute remains as to whether the implications from violations of internal FINRA rules pose a substantial federal issue warranting federal jurisdiction.

### B. The Second Circuit

On August 11, 2016, the Second Circuit decided a case regarding the suitability of federal jurisdiction for violations of FINRA internal rules.<sup>253</sup> Doscher filed for arbitration against his former employers alleging breach of contract, retaliatory discharge, unjust enrichment, and securities fraud under Section 10(b) of the Securities Exchange Act of 1934.<sup>254</sup> After FINRA arbitration, Doscher filed a petition to vacate the

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248. *Id.* at 1068–69.

249. *See id.* at 1069 (noting that if the arbitrators were in violation of FINRA rules, federal jurisdiction would be appropriate).

250. *See id.* (“Section 78aa conferred exclusive jurisdiction on the district court because the central question of this case is whether FINRA rules were violated.”).

251. *See id.* (finding the district court correct in granting subject matter jurisdiction).

252. *See* Merrell Lynch, Pierce, Fenner & Smith Inc. v. Manning, 136 S. Ct. 1562, 1562 (2016) (abrogating *Sparta Surgical* in 2016).

253. *See* Doscher v. Sea Port Grp. Sec., LLC, 832 F.3d 372, 372 (2d Cir. 2016) (“Doscher’s argument that a substantial federal question appears on the face of the petition receives our initial attention.”).

254. *See id.* at 374 (stating that Doscher later amended his claim to add the securities fraud claim).

arbitration award in federal district court.<sup>255</sup> Specifically, Doscher claimed that the arbitration panel failed to make documents available to him in a timely manner.<sup>256</sup> Furthermore, he claimed that the arbitrators disregarded FINRA Rule 13505 by neglecting to force the respondents to cooperate in disclosure.<sup>257</sup> The district court rejected both arguments, stating that violations of internal FINRA rules fail to present a claim for federal subject-matter jurisdiction.<sup>258</sup>

The Second Circuit began its discussion by identifying that federal question jurisdiction is appropriate when the petition claims that the award was given in manifest disregard of federal law.<sup>259</sup> However, the court found that FINRA internal rules do not constitute federal law.<sup>260</sup> Doscher's argument for federal jurisdiction relied on *UBS Securities* and the conclusion that NASDAQ's underlying obligation enforced by the Securities Exchange Act to operate a fair and open market warranted federal jurisdiction.<sup>261</sup> However, the court distinguished Doscher's case from *UBS Securities* because the specific FINRA Rule 13505 merely forced the arbitration panel to require the parties to

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255. *See id.* (identifying the petition as a § 10 petition). The petition is filed under 9 U.S.C. § 10, which is the Federal Arbitration Act. 9 U.S.C. § 10 (2012). The filing of a petition under the Federal Arbitration Act alone does not grant the claim federal subject matter jurisdiction. *See Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 25 n.32 (1983) ("The Arbitration Act is something of an anomaly in the field of federal-court jurisdiction. It creates a body of federal substantive law establishing and regulating the duty to honor an agreement to arbitrate, yet it does not create any independent federal-question jurisdiction under 28 U.S.C. § 1331.").

256. *See Doscher*, 832 F.3d at 374 (noting one of Doscher's grounds for vacatur was that the arbitration panel failed to ensure documentary evidence was timely made available to him).

257. *See id.* (averring federal jurisdiction appropriate due to the manifest disregard of FINRA Rule 13505).

258. *See id.* (finding Doscher's reliance on § 10(b) of the FAA foreclosed).

259. *See id.* at 375 (stating that the law must in fact be federal law to qualify) (citing *Greenberg v. Bear, Stearns & Co.*, 220 F.3d 22, 27 (2d Cir. 2000)). Additionally, under *Wilko*, manifest disregard of the law remains a ground for vacating an arbitration award.

260. *See id.* at 377 ("Doscher's claim does not present a facial claim of any manifest disregard of federal law.").

261. *See id.* at 375 (finding federal jurisdiction appropriate even though the claim was grounded in state law claims).

cooperate with discovery.<sup>262</sup> The rule posed no obligation on FINRA itself. The court then specifically identified the *Sacks* case, noting that the Ninth Circuit did not distinguish between an SRO violating its own internal rules and an arbitrator violating an internal rule.<sup>263</sup> The Second Circuit stated that the appropriateness of federal jurisdiction should differ depending on the identity of the violator.<sup>264</sup> Although the court noted FINRA's obligation to follow its own internal rules under § 78s(g) of the Securities Exchange Act, the court believed that in *Doscher's* and *Sacks's* situations there was no violation of a federal law.<sup>265</sup> The court then went on to dispute the Ninth Circuit's reasoning grounded in 15 U.S.C. § 78aa's grant of exclusive federal jurisdiction for violations of rules under the Securities Exchange Act.<sup>266</sup> The Second Circuit stated that the *Sacks* decision is inconsistent with the recent decision rendered by the Supreme Court in *Manning*.<sup>267</sup> The Court laid out the "arising under" standard for § 78aa, rejecting the broader interpretation found in *Sparta*.<sup>268</sup> The first type of suit that falls under § 78aa is one in which "federal law creates the cause of action asserted."<sup>269</sup> The second type of suit, which could apply to actions such as *Sacks* and *Doscher*, is when the case "necessarily raises a stated federal issue, actually disputed and substantial."<sup>270</sup> However, the Ninth Circuit

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262. *See id.* at 375–76 ("Doscher's claim is, in essence, that the Exchange Act requires FINRA to require the arbitration panel to require the parties to cooperate, and the parties did not cooperate.").

263. *See id.* at 376 (relying on the *Sparta Surgical* case in which NASD violated its own internal rules).

264. *See id.* (finding the Ninth Circuit unpersuasive in its judgment and finding a key difference between an SRO violating its own internal rules and an entity other than an SRO violating the internal rule).

265. *See id.* at 377 ("There is a critical difference between cases like *Sparta* and *NASDAQ* involving allegations that the SRO breached its own internal rules and cases like *Sacks* and *Doscher's* involving allegations that someone other than the SRO violated the internal rules.").

266. *See id.* (noting that the Ninth Circuit's interpretation of § 78aa is no longer reasonable).

267. *See id.* at 376–77 (finding the Ninth Circuit's decision no longer tenable).

268. *See id.* at 377 (stating two types of suits where § 78aa confers federal jurisdiction).

269. *Merrell Lynch, Pierce, Fenner & Smith Inc. v. Manning*, 136 S. Ct. 1562, 1569–70 (2016).

270. *Id.*

stated that the non-Exchange Act action “necessarily depend[ed] on a showing that the *defendant* breached the Exchange Act” or “that the *defendant* infringed a requirement of a federal statute.”<sup>271</sup> Because of the Supreme Court’s reasoning and the absence of a duty created by the Exchange Act to comply with FINRA rules on non-SRO entities, the Ninth Circuit found federal jurisdiction inappropriate under § 78aa.<sup>272</sup>

Despite the claim for manifest disregard of a FINRA rule, the court found no case for federal jurisdiction.<sup>273</sup> However, the “arising under” test now found in § 78aa remains untested, in regard to the substantiality of the federal issue that a violation of an internal FINRA rule presents. If a court finds the issue substantial, then federal jurisdiction would be appropriate under *UBS Securities* and *Manning*.<sup>274</sup>

### C. The Third Circuit

The final case involving the question of whether FINRA rules constitute federal law is *Goldman v. Citigroup Global Markets, Inc.*<sup>275</sup> The Goldmans originally initiated arbitration proceedings against Merrill Lynch and Citigroup Global Markets for losing a substantial portion of their retirement account due to an alleged margin call.<sup>276</sup> The Goldmans asserted multiple causes of action in the arbitration proceeding including violations of the Securities Exchange Act, fraudulent misrepresentation, breach of contract, and negligence.<sup>277</sup> The Goldmans settled their dispute with Merrill

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271. *Id.* at 1569.

272. *Doscher v. Sea Port Grp. Sec., LLC*, 832 F.3d 372, 377 (2d Cir. 2016) (“An action to vacate an arbitration award on either ground therefore falls into neither of *Manning’s* categories.”).

273. *See id.* at 373 (declining to recognize the failure of FINRA to follow its internal rules as manifest disregard of federal law).

274. *See id.* at 377 n.7 (“[W]e think there is no reason to suspect that *Manning* called *NASDAQ* into question, and we are comfortable relying on *NASDAQ’s* reasoning here.”).

275. *Goldman v. Citigroup Glob. Mkts., Inc.*, 834 F.3d 242, 242 (3d Cir. 2016).

276. *See id.* at 246 (stating that the Goldman’s investor originally worked at Merrill Lynch, and then transferred to Citigroup where the investor allegedly engaged in high risk investments for the Goldmans).

277. *See id.* (noting additional claims of lack of supervision of employees, lack of suitability of investment recommendations, and breach of fiduciary duty).

Lynch in mediation, but the dispute between the Goldmans and Citigroup required resolution in arbitration proceedings.<sup>278</sup> During arbitration between the Goldmans and Citigroup, the Goldmans sought interlocutory action from the U.S. District Court stating that the FINRA arbitration panel was partial to the opposing party.<sup>279</sup> Later, with arbitration complete, the Goldmans refiled their motion to vacate the arbitration award.<sup>280</sup> Importantly, the Goldmans alleged that the FINRA arbitration panel behaved improperly.<sup>281</sup> The district court dismissed the Goldmans' claims for lack of subject-matter jurisdiction.<sup>282</sup> In the Goldmans' appeal to the Third Circuit, they claimed federal question jurisdiction on three theories: (1) the arbitration relied on federal securities law; (2) the FINRA panel manifestly disregarded federal law; and (3) FINRA procedural issues are fundamentally related to federal law.<sup>283</sup> The court dismissed the first theory on the idea "that a district court may not look through a § 10 motion to vacate to the underlying subject matter of the arbitration in order to establish federal question jurisdiction."<sup>284</sup> The court then turned to the second theory asserted by the Goldmans. The Goldmans stated that the arbitration panel manifestly disregarded 15 U.S.C. § 78g establishing margin requirements.<sup>285</sup> Through the court's analysis,

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278. *See id.* at 246–47 (stating that among other allegations the Goldmans claimed that Citigroup refused to mediate and Citigroup secretly observed the mediation between Merrill Lynch and the Goldmans).

279. *See id.* at 247 (dismissing the interlocutory appeal, the district court stated that the Goldmans should refile the case when arbitration concluded).

280. *See id.* (submitting the refiled motion to vacate the arbitration award instigated the dispute in this case).

281. *See id.* at 248 ("In their motion, . . . they alleged that the FINRA arbitration panel behaved improperly in that it demanded 'voluminous' and irrelevant discovery from them, did not permit sufficient discovery of CGMI's documents, exhibited partiality towards CGMI, and 'refused to resign' at the Goldmans' request.").

282. *See id.* (stating in the district court opinion that federal question jurisdiction was lacking in the motion to vacate arbitration).

283. *See id.* at 251 (considering each theory in the Third Circuit's opinion).

284. *Id.* at 255.

285. *See id.* at 255–56 (stating that due to the language of § 78g a margin call must have occurred). Both parties claim different stances on this issue. The Goldmans state that there was a devastating margin call, while Citigroup states that no margin call occurred. *See id.* at 247 (stating in the arbitration decision that the Goldmans failed to present any evidence that they were subject to a margin call).

it determined that the Goldmans failed to establish a manifest disregard of federal law because § 78g merely supports their principal complaint, which is that the arbitration panel acted partially and corruptly.<sup>286</sup> Moreover, the Goldmans failed to establish the four parts of the “arising under” standard in their claim that the FINRA arbitration panel manifestly disregarded federal law.<sup>287</sup> Due to these criticisms the court found no federal jurisdiction unwarranted for the allegation of manifest disregard of law.<sup>288</sup>

Finally, the Third Circuit addressed whether FINRA rules constituted federal law.<sup>289</sup> The Goldmans principally relied on *UBS Securities* for their position.<sup>290</sup> Although the court did not dispute *UBS Securities*’s overall holding on federal question jurisdiction, the court distinguished the Goldmans’ case from *UBS Securities* on a factual basis.<sup>291</sup> The Third Circuit stated that a key difference in the Goldmans’ case and *UBS Securities* relied on the substantiality analysis.<sup>292</sup> NASDAQ is an exchange, and the Third Circuit stated that NASDAQ’s role in the federal securities law is much more significant than arbitration procedures of a non-exchange SRO.<sup>293</sup> The court ruled that federal jurisdiction was inappropriate because, “[u]nlike the [*UBS Securities*] case, which implicated the proper functioning of a major national securities

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286. *See id.* at 256 (stating that in order to raise federal question jurisdiction, the petitioner’s complaint must rely *principally* on the manifest disregard of the law) (emphasis added).

287. *See id.* at 257 (“The claim does not ‘necessarily raise a . . . federal issue,’ nor is the federal issue in question ‘substantial.’” (quoting *Grable & Sons Metal Prods., Inc. v. Darue Eng’g & Mfg.*, 545 U.S. 308, 314 (2005))).

288. *See id.* (“In reality, no question of federal law is ‘actually disputed’ here.”) (quoting *Grable & Sons Metal Prods., Inc. v. Darue Eng’g & Mfg.*, 545 U.S. 308, 314 (2005))).

289. *See id.* (alleging that because FINRA is a self-regulatory organization, FINRA rules inherently raise questions of federal law).

290. *See id.* (stating that one of the main issues in *UBS Securities* was whether federal jurisdiction was appropriate despite the fact that the claims were grounded in NASDAQ regulations and New York law).

291. *See id.* at 258 (“[I]ts facts are easily distinguishable from the Goldmans’ case because it ‘involved far more substantial questions of federal law.’”).

292. *See id.* (finding the Second Circuit to weigh substantiality in its holding).

293. *See id.* at 258 (“The substantiality inquiry . . . looks . . . to the importance of the issue to the federal system as a whole.” (quoting *Gunn v. Minton*, 133 S. Ct. 1059, 1066 (2013))).



exchange, nothing about the Goldmans' case is likely to affect the securities markets more broadly."<sup>294</sup> On December 23, 2016, Judith Goldman filed a petition for a writ of certiorari to the Supreme Court of the United States.<sup>295</sup> However, the Goldmans' petition was denied on May 22, 2017.<sup>296</sup>

FINRA arbitrations remain vital to broker and customer disputes.<sup>297</sup> Additionally, investors must rely on this structure for non-disciplinary disputes.<sup>298</sup> When an arbitrator manifestly disregards applicable FINRA internal rules when rendering a decision, the disparaged party may seek vacatur of the arbitration award.<sup>299</sup> The decision by the Second Circuit in *UBS Securities* granted federal jurisdiction over a case where NASD violated its own internal rules.<sup>300</sup> In addition, the holding in *Manning* created the "arising under" standard for § 78aa.<sup>301</sup> Together, these two holdings create a question of suitability of federal jurisdiction for violations of internal FINRA rules.

### V. Argument for Exclusive Federal Jurisdiction

Appeals seeking vacatur of a FINRA arbitration award claiming violations of FINRA internal rules deserve exclusive federal jurisdiction. First, internal FINRA rules should be

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294. *Id.*

295. *See* Goldman v. Citigroup Glob. Mkts., Inc., 834 F.3d 242 (3d Cir. 2016), petition for cert. filed, 2016 WL 7732953 (U.S. Dec. 23, 2016) (No. 16-874).

296. *See* Goldman v. Citigroup Glob. Mkts., Inc., 834 F.3d 242 (3d Cir. 2016), cert. denied (U.S. May 22, 2017) (No. 16-874).

297. *See* Berry, *supra* note 24 (stating that FINRA operates the largest alternative dispute resolution forum in the world).

298. *See* Black, *supra* note 13, at 23 (stating that FINRA is the primary regulator of the securities industry).

299. *See* Wilko v. Swan, 346 U.S. 427, 437 (1953) ("In unrestricted submission, such as the present margin agreements envisage, the interpretations of the law by the arbitrators in contrast to manifest disregard are not subject, in the federal courts, to judicial review for error in interpretation.").

300. *See* NASDAQ OMX Grp., Inc. v. UBS Sec., LLC, 770 F.3d 1010, 1021 (2d Cir. 2014) (examining the failure of NASDAQ to fulfill its duty to operate a fair and orderly market).

301. *See* Merrell Lynch, Pierce, Fenner & Smith Inc. v. Manning, 136 S. Ct. 1562, 1571 (2016) (drawing comparison to the Natural Gas Act in its analysis to prove that specific language in the statute did not necessarily matter).

considered federal law due to the structure of FINRA rule promulgation,<sup>302</sup> courts' stance on preemption of FINRA arbitration rules over state arbitration rules,<sup>303</sup> and FINRA's unique structure as a purely regulatory scheme.<sup>304</sup> Second, finding federal question jurisdiction for manifest disregard of internal FINRA rules conforms to the standards set in *UBS Securities and Manning*.<sup>305</sup> Finally, finding exclusive federal jurisdiction will provide a clear uniform standard in cases involving vacatur from FINRA arbitration awards.<sup>306</sup>

#### A. FINRA Rules are Federal Law

This Note earlier outlined the procedures for promulgation of internal FINRA rules.<sup>307</sup> Advocates arguing for SRO rules as federal law often cited to this procedure, drawing a connection between the federal system of agency rule promulgation and SRO rulemaking procedures.<sup>308</sup> An important feature in this process is the SEC's receipt of the proposed rule from FINRA and then the SEC submission of the rule to its own rulemaking process of notice and comment procedure.<sup>309</sup> This way, the SEC retains direct

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302. See *supra* notes 92–95 and accompanying text (outlining the specific procedures FINRA must go through to promulgate a new rule, modify an old rule, or delete a rule).

303. See *infra* notes 314–315 and accompanying text (demonstrating how some states have viewed SRO arbitration rules in the context of federal preemption).

304. See Karmel, *supra* note 6, at 153 (noting FINRA's monopoly over the regulation of the securities industry).

305. See *infra* Part V.B and accompanying text (examining federal jurisdiction in light of both *Manning* and *UBS Securities*).

306. See *infra* Part V.C and accompanying text (demonstrating the benefits of having a uniform system).

307. See *supra* notes 92–97 and accompanying text (outlining the procedure for promulgation of new FINRA rules and modifications for FINRA rules).

308. See *NASDAQ OMX Grp., Inc. v. UBS Sec., LLC*, 770 F.3d 1010, 1021 (2d Cir. 2014) (“The duty UBS identifies—indeed, the very language it employs—derives directly from federal law. In the Exchange Act, Congress makes plain that ‘maintenance of fair and orderly markets’ is the animating goal of federal securities law.”).

309. See Securities Exchange Act of 1934 § 19(b)(1), 15 U.S.C. § 78s(b)(1) (2012) (“Each self-regulatory organization shall file with the Commission, in accordance with such rules as the Commission may prescribe, copies of any

oversight of any proposed rules, rule changes, or deletions to rules.<sup>310</sup> Additionally, the SEC can create SRO rules without input from the individual SRO.<sup>311</sup> Looking to the legislative history of the Exchange Act Amendments of 1975 provides information important to the idea that SRO Rules be categorized as federal law. The Committee Report states that, “[t]he self-regulatory organizations, it should be emphasized, are intended to be subject to the SEC’s control and have no governmentally derived authority to act independently of SEC oversight.”<sup>312</sup> Moreover, the Committee emphasized that SROs support the overall goals of the Securities Exchange Act.<sup>313</sup> The close link between FINRA and the SEC leads to the conclusion that FINRA rules are federal law.

The context of federal preemption supplements the argument for the characterization of FINRA internal rules as federal law. State courts found problems with SRO rules in the context of federal preemption.<sup>314</sup> In *Jevne v. Superior Court*,<sup>315</sup> the Supreme Court of California found that because the SEC approves all SRO rules, those rules remain important to the overall Securities

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proposed rule or any proposed change in, addition to, or deletion from the rules of such self-regulatory organization . . .”).

310. *See id.*

The Commission shall, as soon as practicable after the date of the filing of any proposed rule change, publish notice thereof together with the terms of substance of the proposed rule change or a description of the subjects and issues involved. The Commission shall give interested persons an opportunity to submit written data, views, and arguments concerning such proposed rule change. No proposed rule change shall take effect unless approved by the Commission or otherwise permitted in accordance with the provisions of this subsection.

311. *See supra* note 98 (identifying the SEC’s option to make SRO rules without the input of the SRO).

312. H.R. REP. NO. 93-1476, at 45 (1974).

313. *See id.* at 46 (“The Committee believes that this redefinition is necessary to make certain that, in the changed economic and technological conditions of today, the regulatory pattern of the securities industry is responsive to and supportive of the basic goals underlying the Securities and Exchange Act of 1934.”).

314. *See generally* *Credit Suisse First Bos. Corp. v. Grunwald*, 400 F.3d 1119 (9th Cir. 2005) (ruling on the status of self-regulatory organization rules in the context of federal preemption over state laws); *Jevne v. Super. Ct.*, 111 P.3d 954 (2005) (finding provisions of the NASD Code in conflict with the California Standards).

315. 111 P.3d 954 (Cal. 2005).

Exchange Act goals of fair dealing and protection of investors.<sup>316</sup> The court concluded that NASD rules preempted California rules regarding arbitrator disclosure.<sup>317</sup> The Ninth Circuit in *Credit Suisse First Boston Corporation v. Grunwald*<sup>318</sup> also found NASD arbitrator standards preempted California standards for appointing arbitrators.<sup>319</sup> The court relied on the requirement of SEC approval for NASD rules despite the fact that NASD was a private organization.<sup>320</sup> Additionally, the court noted that before the 1975 Exchange Act Amendments, the SEC retained limited oversight of proposed rulemaking procedures of SROs.<sup>321</sup> The 1975 Exchange Act Amendments granted the SEC oversight for all SRO rule proposals, deletions, and modifications.<sup>322</sup> It also gave the SEC the option to change or add an SRO rule as the SEC deemed necessary.<sup>323</sup> Based on the 1975 Amendments, the Ninth Circuit ruled that the SRO rules preempted state law.<sup>324</sup> Following this line of reasoning, violations of SRO rules warrant federal question jurisdiction.

*B. Exclusive Federal Jurisdiction Consistent with Precedent*

Cases in the future may grant the Supreme Court with an opportunity to clarify its holding in *Manning*, as well as bring

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316. See *id.* at 964 (noting that conflict preemption was at issue in the case).

317. See *id.* at 969 (“[The] NASD Code’s provisions governing arbitrator selection should prevail over conflicting state law, and this determination is neither arbitrary nor in excess of its statutory authority. Therefore, we conclude that the SEA, through the SEC’s approval of the NASD Code, preempts the California Standards dealing with disclosure and disqualification.”).

318. 400 F.3d 1119 (9th Cir. 2005).

319. See *id.* at 1128 (noting that the issue dealt with SRO rules and not specific SEC regulations).

320. See *id.* (noting the legislative history of the 1975 Amendments to the Securities Exchange Act).

321. See *id.* at 1129 (noting that the Securities and Exchange Commission could only oversee SRO rulemaking procedures in specific subject areas) (citing 15 U.S.C. § 78s(b) (2012)).

322. 15 U.S.C. § 78s(b) (2012).

323. *Id.* § 78s(c).

324. See *Credit Suisse*, 400 F.3d at 1137 (“[W]e agree with the district court’s ultimate conclusion that the Ethics Standards do not apply to NASD arbitrations because the Ethics Standards are preempted by the Exchange Act.”).

continuity to enforcement for violations of internal FINRA rules.<sup>325</sup> While the *Manning* decision creates a narrow test for exclusive federal question jurisdiction under the Securities Exchange Act, violations of FINRA internal rules remain within the scope of the *Manning* decision.<sup>326</sup> Additionally, the scope of the *UBS Securities* decision, as well as the legislative history of the Exchange Act Amendments of 1975, augments the argument that these violations fall under exclusive federal jurisdiction. Expanding the scope of *UBS Securities* provides federal jurisdiction not only to instances of SROs as organizations violating their own internal rules, but also when third parties violate the SRO internal rules.

The decision in *Manning* creates two circumstances where federal jurisdiction applies under the “arising under” test of § 78aa.<sup>327</sup> The first instance requires the federal law to create the cause of action, which remains inapplicable in the argument for violations of internal FINRA rules.<sup>328</sup> The second circumstance provides exclusive federal jurisdiction where a “state-law cause of action is ‘brought to enforce’ a duty created by the Exchange Act because the claim’s very success depends on giving effect to a federal requirement.”<sup>329</sup> Due to the nature of oversight by the SEC of FINRA’s internal rules, violations of the rules give effect to a federal requirement. The opening for interpretation of the *Manning* decision on this specific issue resides in the claims stated by the plaintiff. In *Manning*, the plaintiffs never claimed a violation of an Exchange Act duty, but merely alleged a violation of the New Jersey Uniform Securities Law and relied on the interpretation of the SEC rule.<sup>330</sup> Therefore, the “arising under” test described in the *Manning* decision still allows the possibility

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325. See Dale & Harris, *supra* note 133 (“Thus, notwithstanding *Manning*, we expect to see additional battles regarding the scope of ‘arising under’ federal jurisdiction in the state securities-law context.”).

326. See *Merrell Lynch, Pierce, Fenner & Smith Inc. v. Manning*, 136 S. Ct. 1562, 1577–78 (2016) (Thomas, J., concurring) (stating that the case did rely on the enforcement of a federal duty).

327. See *id.* at 1569 (following the same test for 28 U.S.C. § 1331 jurisdiction).

328. See *id.* (stating that federal jurisdiction is found where a claim originates in the statute, however, in this instance the statute does not create a cause of action).

329. *Id.* at 1570.

330. See *id.* at 1577–78 (Thomas, J., concurring) (“Vindicating that claim would not require the enforcement of a federal duty or liability.”).

of federal jurisdiction for violations of FINRA rules. The Second Circuit in *Doscher* construed *Manning* and disputed the fact that the Exchange Act imposed a duty to comply with FINRA rules on arbitrators.<sup>331</sup> While *Sacks* and *Sparta* present analysis on the discontinued test of § 78aa of the Exchange Act,<sup>332</sup> the analysis of the SEC's control over SROs remains pertinent. Moreover, the impact of the FINRA arbitration process on the system of national securities as a whole presents a substantial federal issue when violations of FINRA rules occur. Violation of FINRA arbitration procedures raises a substantial federal issue due to the amount of FINRA arbitrations conducted each year<sup>333</sup> and the importance of arbitration to investors and brokers.<sup>334</sup>

The Third Circuit in *Goldman* stated that circumstances like that of *Goldman* and *Doscher* remain inconsequential compared to the circumstances in *UBS Securities* where an SRO as an entity violated its own internal rules.<sup>335</sup> However, FINRA now remains the leading SRO requiring all brokers-dealers to register with it.<sup>336</sup> Therefore, the implications from violations of internal FINRA rules, no matter the entity involved, could broadly affect the federal securities industry.

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331. See *Doscher v. Sea Port Grp. Sec., LLC*, 832 F.3d 372, 377 (2d Cir. 2016) (“An action to vacate an arbitration award on either ground therefore falls into neither of *Manning*’s categories.”).

332. See *Manning*, 136 S. Ct. at 1568 (relying on the “brought to enforce” language found in § 78aa to grant federal jurisdiction expansively).

333. See *Berry*, *supra* note 24 (stating that FINRA conducts between 4,000 and 8,500 arbitrations per year).

334. See Andrew C. Spacone et al., *Broker-Dealer Liability: Are the Rules Pertaining to Providing Investment Advice to Retail Customers About Change?*, 64 R.I. B.J. 13, 15 (2016) (“[A] majority of individual broker-dealer disputes that are adjudicated result in FINRA arbitration.”).

335. See *Goldman v. Citigroup Glob. Mkts., Inc.*, 834 F.3d 242, 258 (3d Cir. 2016) (“Unlike the [*UBS Securities*] case, which implicated the proper functioning of a major national securities exchange, nothing about the Goldmans’ case is likely to affect the securities markets more broadly.”).

336. See 15 U.S.C. § 78o (2012) (requiring all broker-dealers to register with a self-regulatory organization).

*C. Exclusive Federal Jurisdiction Provides a Clear  
Uniform Standard*

Commentators on the *Manning* case also expressed concern with the specific application of the decision.<sup>337</sup> The Court's decision in *Manning*, applying the "arising under" standard to § 78aa, specifically creates a new problem for state courts. Because § 78aa confers exclusive jurisdiction and not concurrent jurisdiction as with § 1331, state courts must now analyze securities cases to make sure that the dispute does not fall within exclusive federal jurisdiction.<sup>338</sup> Thus, plaintiffs retain the power to word their complaints without reference to securities in order to avoid federal jurisdiction.<sup>339</sup> Future securities cases may present the Supreme Court with an opportunity to clarify its analysis established in *Manning*,<sup>340</sup> by providing an analysis to determine whether asserting a violation of an internal FINRA rule creates a "stated federal issue, actually disputed and substantial, which a federal forum may entertain without disturbing any congressionally approved balance of federal and state power."<sup>341</sup> After the holding in *Manning*, state courts now must evaluate plaintiff's claims involving violations of FINRA rules under the "arising under"

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337. See generally, Case Comment, *supra* note 56, at 425 (construing the Supreme Court's holding and noting its difficulties in future application); see Dale & Harris, *supra* note 133 (stating that there remains some ambiguity as to how much a plaintiff must discuss federal securities law in order for a court to find federal jurisdiction appropriate).

338. See *id.* at 426 ("However, section [78aa] establishes exclusive federal jurisdiction, rather than concurrent federal jurisdiction as § 1331 does. As a result, it obliges state courts to undertake an additional line of inquiry to ensure that a cause of action does not fall under federal courts' exclusive jurisdiction before proceeding.").

339. See Dale & Harris, *supra* note 133 ("[A] future plaintiff who wishes to stay in state court may play it safe by 'purg[ing] his complaint of any references to federal securities law, so as to escape removal.'" (quoting *Merrell Lynch, Pierce, Fenner & Smith Inc. v. Manning*, 136 S. Ct. 1562, 1575 (2016))).

340. See *id.* ("Indeed, the Supreme Court's opinion provides no guidance on how to apply the 'arising under' standard in § 1331 to situations like the one presented in *Manning*, where the allegations of the complaint explicitly referenced violations of federal securities law without turning on them.").

341. *Merrell Lynch, Pierce, Fenner & Smith Inc. v. Manning*, 136 S. Ct. 1562, 1570 (2016) (quoting *Grable & Sons Metal Prods., Inc. v. Darue Eng'g & Mfg.*, 545 U.S. 308, 3114 (2005)).

test.<sup>342</sup> This evaluation may lead to different results depending on the certain FINRA violations claimed. However, providing exclusive jurisdiction to violations of internal FINRA rules augments a uniform standard, and allows state courts to expedite the difficult application of “arising under” analysis.

Exclusive federal jurisdiction for violations also promotes uniformity in the securities industry. With the difficulty in application of securities standards, exclusive federal jurisdiction prevents differing standards among jurisdictions regarding a comprehensive federal securities industry. Moreover, the federal courts may be better equipped to handle disputes arising from securities arbitration due to their knowledge of the federal system as a whole.

## VI. Conclusion

Regulation of the securities industry changed drastically throughout the nation’s history. SROs began as private agreements between individuals trading in the markets to ensure honesty and reliability. Often after economic downturns, SROs made broad changes to their policies and implementation of regulations. After the Stock Market Crash in 1929, the federal government, through the SEC, began oversight of the SROs. Since then, the SEC became increasingly involved in the SRO’s regulation of the securities markets.

SROs retain a unique status within the nation’s administrative structure. FINRA retains an additional uniqueness due to its lack of a securities exchange. However, broad oversight of FINRA remains consistent, and may even increase in the future. Yet FINRA’s immense impact on the securities industry remains undeniable. FINRA’s large-scale arbitration and its close interrelation to the SEC support the idea of a quasi-governmental entity. Therefore, in alignment with the holdings in *UBS Securities* and *Manning*, violations of its internal rules warrant exclusive federal jurisdiction. While *Birdthistle* and *Henderson* discourage

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342. See Case Comment, *supra* note 56, at 426 (“Thus, a § 1331 inquiry unilaterally imposes burdens on federal courts to ensure they may properly exert jurisdiction.”).



the idea of further taking the “self” out of self-regulation,<sup>343</sup> the SEC already retains this broad oversight of FINRA rules. Due to the SEC’s decision-making power over FINRA, federal courts remain best-equipped to interpret these rules.

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343. See Birdthistle & Henderson, *supra* note 10, at 4 (“We hypothesize that the rational government would ideally like to maintain the public/private distinction, but there are forces inexorably driving the government and the various other players into a less optimal equilibrium.”).