Securities Regulation Daily Wrap Up, ARBITRATION—2d Cir.: Federal court may 'look through' petition to vacate arbitration award, (Aug. 11, 2016)

Securities Regulation Daily Wrap Up

Click to open document in a browser

By John M. Jascob, J.D., LL.M.

Federal courts may "look through" petitions in determining whether jurisdiction exists to vacate or modify arbitration awards under Section 10 of the Federal Arbitration Act, the Second Circuit has held. Although the appellant's petition did not present a facial claim that a FINRA panel manifestly disregarded federal law, the Second Circuit overruled its own precedent and held that the district court could "look through" the petition to determine if the underlying dispute involved substantial questions of federal law (*Doscher v. Sea Port Group Securities, LLC*, August 11, 2016, Wesley, R.).

Arbitration and petition for vacatur. Drew Doscher commenced arbitration in June 2013 against his former employers, The Seaport Group, LLC and Sea Port Group Securities, LLC, both of which are FINRA members. Doscher's amended statement of claim alleged, among other things, breach of contract, retaliatory discharge, and securities fraud under Exchange Act Section 10(b). Although Doscher sought more than $15 million in damages, the arbitral panel awarded him approximately $2.3 million, with a potential additional commission.

In January 2015, Doscher filed petition with the Southern District of New York to vacate and modify the award under Section 10 of the Federal Arbitration Act. Doscher's petition identified two grounds for vacatur: (1) the arbitration panel failed to ensure that documentary evidence was fully and timely made available to Doscher; and (2) the arbitration panel acted in manifest disregard of FINRA Rule 13505, which requires parties to cooperate in discovery. The district court rejected both arguments, holding that: (1) violations of internal FINRA rules do not present questions of federal law; and (2) the holding in *Greenberg v. Bear, Stearns & Co.* (2d Cir. 2000) precluded use of the so-called "look-through" approach in determining the existence of federal question jurisdiction based on Doscher's Section 10(b) claim.

Unstable foundation for facial claim. The Second Circuit began by determining whether Doscher's petition presented a facial claim of any manifest disregard of federal law. Doscher argued that FINRA's internal rules are federal law because the Exchange Act requires FINRA to subject its rules to SEC approval, abrogation, or modification, and because SROs are obligated to comply with their own rules.

The appellate court concluded, however, that the facial claim argument was built on an unstable foundation. While Doscher was required to allege that the arbitration panel manifestly disregarded a rule of federal law, federal law imposes obligations only on SROs—not on arbitration panels applying their rules. Moreover, FINRA Rule 13505 stands even one step further removed because the rule requires cooperation from the parties, and not FINRA itself. Thus, the only federal obligation was the one imposed by the Exchange Act on FINRA, and none of FINRA's conduct was implicated by Doscher's petition.

The Second Circuit distinguished Doscher's case from *NASDAQ OMX Group, Inc. v. UBS Securities, LLC* (2d Cir. 2014), in which the court held that the federal obligation imposed on an SRO to operate a fair and orderly market was a necessary element of the plaintiffs' state law claims. The appellate court was also unpersuaded by *Sacks v. Dietrich* (9th Cir. 2011), where the Ninth Circuit held that federal question jurisdiction extended to claims premised on violations of internal FINRA rules by arbitrators. The Second Circuit found a critical difference between cases like *NASDAQ*, which involved allegations that the SRO breached its own internal rules, and cases like *Sacks* and Doscher's, which involved allegations that someone other than the SRO violated the internal rules.

More importantly, the Second Circuit stated, the conclusion in *Sacks* is no longer tenable following the Supreme Court's decision in *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Manning*. In *Manning*, the high court held that Exchange Act Section 27, which places lawsuits brought to enforce the Act and its rules in federal court, establishes the same jurisdictional test as the "arising under" test of the general federal question statute. As the Exchange Act itself imposes no duty to comply with FINRA rules either on the arbitrators or non-SRO parties to arbitration, an action to vacate an arbitration award does not fall into either of *Manning's* two jurisdictional categories, the Second Circuit panel concluded.

Federal question jurisdiction. Next, the appellate panel turned to Doscher's assertion that his Section 10(b) claim in the underlying arbitration conferred federal question jurisdiction. The district court had concluded that *Greenberg* "squarely foreclosed" Doscher's reliance on the 10(b) claim. Although noting that the district court had correctly applied *Greenberg*, the appellate panel held that the Supreme Court's subsequent decision in *Vaden v. Discover Bank* (U.S. 2009) required the overruling of *Greenberg*. In *Vaden*, the Supreme Court held that a federal court may "look through" a petition to compel arbitration under Section 4 of the Federal Arbitration Act in order to determine whether the petition is predicated on an action that "arises under" federal law.

After a lengthy analysis and discussion of whether the textual difference between Section 4 and Section 10 means that a look-through approach applies only to the former, the Second Circuit panel adopted the following principles concerning the existence of federal question jurisdiction over a petition under the Federal Arbitration Act. First, the existence of federal question jurisdiction over a petition turns on whether the district court would possess jurisdiction over the underlying dispute under the standards of the general federal question statute (28 U.S.C. §1331). Second, the "save for" clause in Section 4 evinces congressional authorization for the remedy of compulsion of arbitration in any district court with jurisdiction. Third, the Federal Arbitration Act's other sections similarly authorize particular courts with jurisdiction to issue particular remedies but do not affect the jurisdictional inquiry.

Based on this analysis, the appellate panel concluded that *Vaden* rendered *Greenberg's* result fundamentally inconsistent with the Federal Arbitration Act's statutory context and judicial interpretations. Accordingly, the Second Circuit overruled *Greenberg* and adopted the rule that a federal district court faced with a Section 10 petition may "look through" the petition to the underlying dispute, applying to it the ordinary rules of federal question jurisdiction and the principles laid out in *Vaden*. As the district court did not conduct an analysis of the underlying dispute, the order and the judgment were vacated and the matter was remanded for consideration of that question.

The case is No. 15-2814.

Attorneys: Angelo Todd Merolla (Merolla and Gold, LLP) for Drew Doscher. Ronald Blum (Manatt, Phelps & Phillips, LLP) for Sea Port Group Securities, LLC, The Seaport Group, LLC, Armory Advisers, LLC and Armory Fund, LP.

Companies: Sea Port Group Securities, LLC; The Seaport Group, LLC; Armory Advisers, LLC; Armory Fund, LP

LitigationEnforcement: Arbitration BrokerDealers ConnecticutNews NewYorkNews VermontNews