UNITED STATES DISTRICT COURT
MIDDLE DISTRICT OF FLORIDA
JACKSONVILLE DIVISION

MERRILL LYNCH, PIERCE, FENNER & SMITH, INCORPORATED,

Plaintiff,

v. **Case No.: 3:17-cv-1259-J-20JRK**

DAVID MIDDLETON,

Defendant.
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ORDER

This matter is before this Court on Defendant's Motion to Dismiss or, in the Alternative, Stay Proceedings and Compel Arbitration and Incorporated Memorandum of Law (Dkt. 12) and Plaintiff's Memorandum in Support of Motion for Preliminary Injunction Against Proceeding in FINRA Arbitration (Dkt. 13) and the responses and declaration thereto (Dkts. 19, 21, 24, 25, and 27).

Background

Merrill Lynch, Pierce, Fenner & Smith Incorporated ("MLPF&S") brought this action asking this Court to enjoin a Financial Industry Regulatory Authority ("FINRA") arbitration claim brought against it by a former shareholder ("Middleton") of Merrill Lynch & Co., Inc. ("ML & Co."). FINRA, a non-profit corporation registered with the Securities and Exchange Commission, regulates securities firms and investment advisors.

In the FINRA arbitration proceedings, Middleton asserts that his ML & Co. stock holdings declined because ML & Co., and its senior management, failed to disclose to

shareholders the full extent of ML & Co.'s exposure to subprime mortgages and mortgage-related securities in the years leading up to the financial crisis. Middleton seeks to recover the decline in value of his ML & Co. stock holdings that allegedly resulted when those risks became known. Middletown brought his FINRA claim against MLPF&S, the broker with whom he held his ML & Co. stock.

Middleton was an MLPF&S employee and a registered FINRA Associated Person. Upon entering an employment relationship with Middleton, MLPF&S was required to submit a Uniform Application for Securities Industry Registration or Transfer ("Form U4 ") for each individual. A Form U4 contains an arbitration clause, which requires an employee to "arbitrate any dispute, claim or controversy that may arise between me and my firm, or a customer, or any other person, that is required to be arbitrated under the rules, constitutions, or by-laws of [FINRA] . . . ." (Dkt. 12-2).

During Middleton's MLPF&S employment, part of his compensation came in the form of shares or stock options issued by MLPF&S' affiliate — ML & Co. This portion of Middleton's compensation was deposited into MLPF&S brokerage accounts; accounts MLPF&S required all employees to open and maintain during their employment.

At the time MLPF&S opened Middleton's account, MLPF&S required Middleton to sign a customer agreement. Middleton's customer agreement contains language similar to the following:

> Any arbitration pursuant to this provision shall be conducted only before the Financial Industry Regulatory Authority, Inc. (FINRA) or an arbitration facility provided by any other exchange of which Merrill Lynch is a member, and in accordance with the respective arbitration rules then in effect in FINRA or such other

exchange.[1]

On August 21, 2014, MLPF&S and its parent company Bank of America entered into a record $17 billion settlement with the United States Department of Justice to resolve fraud charges. In documents filed with the Securities and Exchange Commission and U.S. Department of Justice, MLPF&S and Bank of America both signed admissions of wrongdoing. The DOJ settlement materials revealed fraud and presented data not previously available to the public or ever disclosed by MLPF&S or Bank of America. This fraud ultimately destroyed ML & Co.'s share value.

The significant depreciation in ML & Co. share value caused by MLPF&S' concealed

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[1] MLPF&S does not contest the language of the standard customer agreement, but importantly MLPF&S has not provided Middleton's customer agreement to this Court. MLPF&S' current Client Relationship Agreement provides in relevant part:

> This Agreement contains a predispute arbitration clause. By signing an arbitration agreement the parties agree as follows:
>
> - All parties to this Agreement are giving up the right to sue each other in court, including the right to trial by jury, except as provided by the rules of the arbitration forum in which a claim is filed . . . . .
>
> You agree that all controversies that may arise between us shall be determined by arbitration. Such controversies include, but are not limited to, those involving any transaction in any of your accounts with Merrill Lynch, or the construction, performance or breach of any agreement between us, whether entered into or occurring prior, on or subsequent to the date hereof.
>
> Any arbitration pursuant to this provision shall be conducted only before the Financial Industry Regulatory Authority, Inc. (FINRA) or an arbitration facility provided by any other exchange of which Merrill Lynch is a member and in accordance with the respective arbitration rules then in effect in FINRA or such other exchange.

(Dkt. 27, Ex. A, pg. 3).

fraud resulted in dramatic losses in Middleton's brokerage account held by MLPF&S. The losses to Middleton's account exceed $20 million on his ML & Co. shares and stock options. Middleton's FINRA arbitration asserts claims and damages related to the loss of stock value as but one of several measures of damages that will be presented at a final hearing.

Standards of Review

Middleton seeks dismissal of this action pursuant to Rules 12(b)(1) & (3) of the Federal Rules of Civil Procedure. A motion under Rule 12(b)(1) challenges a court's subject matter jurisdiction either facially or factually. *Lawrence v. Dunbar*, 919 F.2d 1525, 1528 (11th Cir. 1990). A facial attack "'require[s] the court merely to look and see if [the] plaintiff has sufficiently alleged a basis of subject matter jurisdiction, and the allegations in his complaint are taken as true for the purposes of the motion.'" *Id.* at 1528-29 (quoting *Menchaca v. Chrysler Credit Corp.*, 613 F.2d 507, 511 (5th Cir. 1980)). A factual attack "challenge[s] 'the existence of subject matter jurisdiction in fact, irrespective of the pleadings, and matters outside the pleadings, such as testimony and affidavits are considered,'" *Lawrence*, 919 F.2d at 1529 (quoting *Menchaca*, 613 F.2d at 511). Thus in a factual challenge, a district court may consider extrinsic evidence. 919 F.2d at 1529. Further, there is no presumption of truth to a plaintiff's allegations under a factual challenge. *Id.* (citing *Mortensen v. First Fed. Sav. & Loan Ass'n*, 549 F.2d 884, 891 (3rd Cir. 1977)).

As for Rule 12(b)(3), the Eleventh Circuit has explained this rule "is a somewhat unique context of dismissal in which we consciously look beyond the mere allegations of a complaint, and, although we continue to favor the plaintiff's facts in the context of any actual evidentiary dispute, we do not view the allegations of the complaint as the exclusive basis for decision."

Estate of Myhra v. Royal Caribbean Cruises, Ltd., 695 F.3d 1233, 1239 (11th Cir. 2012).

MLPF&S seeks a preliminary injunction. The standard utilized by this Court in consideration of a motion for preliminary injunction is well-settled in this Circuit.

> The movant must demonstrate: (1) a substantial threat that he will suffer irreparable harm if an injunction is not issued; (2) a substantial likelihood that he will prevail on the merits of the claim; (3) that the threatened injury to the plaintiff outweighs any injury an injunction will cause the opponent; and (4) that granting the injunction is not against the public interest.

Shell Oil Co. v. Altina Assocs., Inc., 866 F. Supp. 536, 541 (M.D. Fla. 1994) (citing *Cheffer v. McGregor*, 6 F.3d 705, 709-10 (11th Cir. 1993) and Fed. R. Civ. P. 65). "The preliminary injunction is an extraordinary and drastic remedy not to be granted until the movant 'clearly carries the burden of persuasion' as to the four prerequisites. 'The burden of persuasion in all of the four requirements is at all times upon the [movant].'" *United States v. Jefferson Cty.*, 720 F.2d 1511, 1519 (11th Cir.1983) (quoting *Canal Auth. of State of Florida v. Callaway*, 489 F.2d 567, 573 (5th Cir.1974)); *accord Cunningham v. Adams*, 808 F.2d 815, 819 (11th Cir.1987); *Zardui- Quintana v. Richard*, 768 F.2d 1213, 1216 (11th Cir.1985).

A showing of irreparable injury is "'the sine qua non of injunctive relief.'" *Northeastern Fla. Chapter of the Ass'n of Gen. Contractors v. City of Jacksonville*, 896 F.2d 1283, 1285 (11th Cir.1990)(quoting *Frejlach v. Butler*, 573 F.2d 1026, 1027 (8th Cir.1978)). Thus, a movant must show "a substantial likelihood that they would suffer irreparable injury" to be granted a preliminary injunction. *Deerfield Med. Ctr. v. City of Deerfield Beach*, 661 F.2d 328, 338 (5th Cir. Unit B Nov. 1981); *see also Beacon Theatres, Inc. v. Westover*, 359 U.S. 500, 506-07 (1959)("The basis of injunctive relief in the federal courts has always been irreparable harm and inadequacy of legal remedies.").

Discussion

A. FINRA Background and Rules

The Securities Exchange Act of 1934 ("Exchange Act") requires that persons "who wish to use any instrumentality of interstate commerce to transact in securities must join an association of brokers and dealers registered as a national securities association. 15 U.S.C. § 78o(a)(1), (b)(1)." *Turbeville v. Fin. Indus. Regulatory Auth.*, 874 F.3d 1268, 1270 (11th Cir. 2017). Registered national securities associations, under the Exchange Act, are directed to "establish membership and conduct rules 'designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, . . . to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest . . . .'" *Id.* (quoting § 78o-3(b)(6)).

"When member brokers or dealers violate the rules of a national securities association or any provision of the Exchange Act, the association can—indeed, must—levy sanctions that carry the force of federal law." *Id.* FINRA, one of these national associations, "oversees and regulates securities firms who join its membership, individuals who work for those firms, and individuals associated with those firms." *Id.* at 1270–71. Importantly for this matter, "When its member brokers or associated persons violate FINRA's rules, FINRA disciplines them pursuant to the Exchange Act's requirements." *Id.* at 1271.

FINRA Rules 12200 and 13200 and the definitions of "Associated Person", and "Person Associated with a Member" are at issue here. Rule 12200 provides,

12200. Arbitration Under an Arbitration Agreement or the Rules of FINRA

Parties must arbitrate a dispute under the Code if:

- Arbitration under the Code is either:

  (1) Required by a written agreement, or

  (2) Requested by the customer;

  - The dispute is between a customer and a member or associated person of a member; and

  - The dispute arises in connection with the business activities of the member or the associated person, except disputes involving the insurance business activities of a member that is also an insurance company.

(Dkt. 14-11, pg. 8). Rule 13200 states:

13200. Required Arbitration

(a) Generally

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.

(b) Insurance Activities

Disputes arising out of the insurance business activities of a member that is also an insurance company are not required to be arbitrated under the Code.

FINRA Rule 13200,

http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4203 (last visited Feb. 2, 2018).

Terms Associated Person is defined, "The term 'associated person' or 'associated person

of a member' means a person associated with a member, as that term is defined in paragraph (u)." (Dkt. 14-11, pg. 3). Finally, a Person Associated with a Member is defined as:

> **(u) Person Associated with a Member**
>
> The term "person associated with a member" means:
>
> > (1) A natural person who is registered or has applied for registration under the Rules of FINRA; or
> >
> > (2) A sole proprietor, partner, officer, director, or branch manager of a member, or other natural person occupying a similar status or performing similar functions, or a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member, whether or not any such person is registered or exempt from registration with FINRA under the By-Laws or the Rules of FINRA.
> >
> > For purposes of the Code, a person formerly associated with a member is a person associated with a member.

(Dkt. 14-11, pg. 4).

B. Motion to Dismiss

Middleton explains this dispute must be resolved through FINRA arbitration since his claims originated with his employment relationship with MLPF&S, and from his customer relationship with MLPF&S. It is Middleton's position that by signing the Form U4 he agreed to FINRA arbitration of "any dispute, claim or controversy that may arise between me and my firm, or a customer, or any other person, that is required to be arbitrated under the rules, constitutions, or by-laws of [FINRA] . . . ." In addition, FINRA Rules 13200 and 12200 require arbitration of all disputes between FINRA members and associated persons if the dispute arises out of their business activities.

MLPF&S, on the other hand, maintains customers of a FINRA member may bring an

arbitration claim against that member only if the dispute is between the customer and member and only if "[t]he dispute arises in connection with the business activities of the FINRA member." FINRA Rule 12200. Middleton's claim, according to MLPF&S, fails both of these requirements.

Middleton seeks dismissal of this action in light of the FINRA arbitration, or alternatively, to compel the parties to proceed with the FINRA arbitration based on the Federal Arbitration Act ("FAA"). The FAA "embodies a liberal federal policy favoring arbitration agreements and seeks to relieve congestion in the courts and to provide parties with an alternative method for dispute resolution that is speedier and less costly than litigation." *Walthour v. Chipio Windshield Repair, LLC*, 745 F.3d 1326, 1329 (11th Cir. 2014) (citations and internal quotations omitted). Under § 2 of the FAA, written arbitration agreements in a contract "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. Further, "[c]onsistent with the FAA's text, courts must rigorously enforce arbitration agreements according to their terms, including terms that specify with whom the parties choose to arbitrate their disputes." *Walthour*, 745 F.3d at 1329-30 (citations and internal quotations omitted). The FAA mandates that when a court concludes an issue is "referable to arbitration under an agreement in writing for such arbitration" the court "shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement . . . ." 9 U.S.C. § 3. Furthermore, the FAA "establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability."

Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24–25 (1983).

However, as an alternative, when all claims are referable to arbitration, a court may order a dismissal of the proceedings rather than order a stay. *See Caley v. Gulfstream Aero. Corp.*, 428 F.3rd 1359 (11th Cir. 2005) (in which the Eleventh Circuit affirmed the district court's order dismissing the case and compelling arbitration where all claims were referable to arbitration). The FAA also allows "a party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration" to request the court to order arbitration "in the manner provided for in such agreement." 9 U.S.C. § 4.

Here this Court finds Middleton and MLPF&S are bound by valid arbitration agreements due to the customer relationship springing from MLPF&S' management of Middleton's broker able account, FINRA Rules 12200 and 13200, and Middleton's Form U4. Therefore, Middleton's claims must be decided by FINRA arbitration.

Specifically, Rule 13200 directs arbitration when "the dispute arises out of the business activities of a member or an associated person . . . ." This phrase has been defined to mean any dispute that the parties could reasonably expect to be appropriate for arbitration in FINRA. *See Valentine Capital Asset Mgmt., Inc. v. Agahi*, 174 Cal. App. 4th 606, 615 (2009) (explaining "[t]he mandate to arbitrate disputes arising out of 'business activities of . . . an associated person,' reasonably read, must require arbitration of disputes only if they arise out of the business activities of an individual as an associated person of a FINRA member."); *Williams v. Imhoff*, 203 F.3d 758, 765 (10th Cir. 2000) (explaining similar language under NASD—FINRA's predecessor—"must be broadly construed to mean 'originating from', 'growing out of,' or 'flowing from.'").

Middleton alleges MLPF&S securitized, marketed, and sold fraudulent financial products, and this fraud damaged his brokerage accounts and his employee compensation. The fraudulent creation of financial instruments by a FINRA member firm appears to fit squarely within not only Rule 12200's broad language but also within Rule 13220 and Middleton's U4. Middleton's claims, therefore, are within the broad scope of the multiple, valid, and binding arbitration agreements between Middleton and MLPF&S. Importantly, even if this Court entertained doubts about the scope of arbitrable issues, the Supreme Court has explained those doubts must be resolved in favor of arbitration. *Moses H. Cone Mem. Hosp.*, 460 U.S. at 24-25.

In sum, the parties are bound by the valid arbitration agreements, therefore, the FAA dictates the outcome — the parties must arbitrate. Accordingly, this Court will compel MLPF&S to proceed in the pending FINRA arbitration. Based on that conclusion, this Court determines that MLPF&S' request for a preliminary injunction is due to be denied.

Accordingly, it is so **ORDERED**:

1. Defendant's Motion to Dismiss or, in the Alternative, Stay Proceedings and Compel Arbitration and Incorporated Memorandum of Law (Dkt. 12) is **GRANTED** to the extent that this case is administratively stayed pending the FINRA arbitration proceedings; and

2. Plaintiff's Memorandum in Support of Motion for Preliminary Injunction Against Proceeding in FINRA Arbitration (Dkt. 13) is **DENIED**.

DONE AND ORDERED at Jacksonville, Florida, this 7th day of February, 2018.

HARVEY E. SCHLESINGER
UNITED STATES DISTRICT JUDGE

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