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DEFINING WHO IS A CUSTOMER IN FINRA ARBITRATION: TIME TO CLEAR THINGS UP!

*By George H. Friedman**

Investors also should have the unencumbered right to seek redress in all available forums…. Section 921(a) of the Dodd-Frank Act authorizes the Commission to prohibit or restrict mandatory pre-dispute arbitration provisions in customer agreements, if such rules are in the public interest and protect investors. The authority covers broker-dealers and investment advisers. I believe the Commission needs to be proactive in this important area. We need to support investor choice.

--- SEC Commissioner Luis A. Aguilar[1]

Introduction

With this statement, Commissioner Aguilar fired the opening salvo in what will undoubtedly be a highly charged debate over whether brokerage firms will be permitted to continue using predispute arbitration agreements ("PDAAs") in customer agreements. While it's a long road from one SEC commissioner's expression of views to promulgation and approval of a rule banning PDAAs, we must now at least entertain the possibility that PDAAs in brokerage and investment adviser [2] accounts will be banned. And if that happens, then defining clearly the term "customer" will quickly become of key importance.

Why? Because if PDAAs are banned[3] then customers will have two roads to arbitration: 1) a post-dispute agreement to arbitrate entered into by all parties – an unlikely occurrence given that one party typically has a strategic or tactical reason not to agree once a dispute has arisen;[4] or 2) through FINRA'S Rule 12200, which requires brokers to arbitrate upon the demand of a customer.[5] So, in a world where PDAAs are banned in customer-broker agreements, the most likely way a customer will have access to FINRA arbitration is via Rule 12200, which FINRA states will not go away even if the SEC bans PDAAs.[6] And Commissioner Aguilar's emphasis on investor choice presages support for FINRA's position. But, the meaning of the term "customer" for purposes of access to the FINRA arbitration forum under Rule 12200 remains somewhat unclear.

This article covers recent regulatory and legal developments on the question of how the term "customer" has come to be defined and interpreted for access to FINRA arbitration via Rule 12200. It updates a June 2012 article appearing in this publication, *"Know Your Customer!? Who is your 'Customer'?,"* (2011 SAC, No. 2), and

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concludes that, given the possibility that PDAAs may be banned by the SEC, and the continued inconsistency in how courts are interpreting Rule 12200, it behooves FINRA to clarify its rules defining the term "customer" as it pertains to access to its arbitration forum. The article closes by proposing a new definition based on what the courts are telling us.

FINRA's Rules

Let's start with Rule 12200, which appears in the Code of Arbitration Procedure for Customer Disputes ("Customer Code"). The rule states in its entirety:

> **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 [emphasis added].

So, absent a PDAA and assuming the dispute arises out of the broker's "business activities," this rule allows a "customer" to require the broker to arbitrate. Simple enough. How then is that term defined? One might logically turn to FINRA's rules governing its members to see if they define "customer" and indeed they do. For example, FINRA Rule 0160, appearing in the "general standards" section establishes the definition of "customer:"

> **0160. Definitions**
>
> **(a)** The terms used in the Rules, if defined in the FINRA By-Laws, shall have the meaning as defined in the FINRA By-Laws, unless a term is defined differently in a Rule, or unless the context of the term within a Rule requires a different meaning.
>
> **(b)** When used in the Rules, unless the context otherwise requires…
>
> **(4) "Customer"**
>
> The term "customer" shall not include a broker or dealer.

This is rather broad, and defines the term by saying what a customer is not. Let's continue our search for meaning.

FINRA Rule 1250(b)(1) covering the "firm element" (continuing training requirements) provides:

> **(b) Firm Element**

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(1) Persons Subject to the Firm Element

The requirements of this subparagraph shall apply to any person registered with a member who has direct contact with customers in the conduct of the member's securities sales, trading and investment banking activities, any person registered as an operations professional … and to the immediate supervisors of such persons (collectively, "covered registered persons"). *"Customer" shall mean any natural person and any organization, other than another broker or dealer, executing securities transactions with or through or receiving investment banking services from a member* [emphasis added].

So, at least for determining who is covered by the firm element, we have added a transactional aspect to the definition.

And then there's Regulatory Notice 12-55, issued last December, which provides guidance on FINRA's suitability rule. It, too, defines customer:

Q6(a). What constitutes a "customer" for purposes of the suitability rule?

A6(a). The suitability rule applies to a broker-dealer's or registered representative's recommendation of a security or investment strategy involving a security to a "customer." *FINRA's definition of a customer in FINRA Rule 0160 excludes a "broker or dealer." In general, for purposes of the suitability rule, the term customer includes a person who is not a broker or dealer who opens a brokerage account at a broker-dealer or purchases a security for which the broker-dealer receives or will receive, directly or indirectly, compensation even though the security is held at an issuer, the issuer's affiliate or a custodial agent (e.g., "direct application" business ,"investment program" securities, or private placements), or using another similar arrangement* [emphasis added and footnotes omitted].

Another transactional aspect. If one stopped the search for meaning here, one might conclude that FINRA's rules actually do define "customer" rather clearly. But alas that's not the case insofar as arbitration is concerned. Rule 1250(b)(1) and Regulatory Notice 12-55 are *contextual* – they define "customer" in context. Rule 1250(b)(1) defines customer for firm element purposes. Regulatory Notice 12-55 defines customer for suitability purposes. But doesn't Rule 0160 above define customer for arbitration purposes? Not really. The rule has an important caveat that's worth repeating:

> The terms used in the Rules, if defined in the FINRA By-Laws, shall have the meaning as defined in the FINRA By-Laws, *unless a term is defined differently in a Rule, or unless the context of the term within a Rule requires a different meaning* [emphasis added].

One can find more definitions of "customer" in the FINRA rules, but in each instance the term is defined in context:

- See, for example, FINRA Rule 2261(c), which sets forth a customer's right to inspect certain financial records of a FINRA member: "As used in paragraph (a) of this Rule, the term 'customer' means any person who, in the regular course of such member's business, has cash or securities in the possession of such member."
- Or Rule 4210(a)(3) with respect to margin: "The term 'customer' means any person for whom securities are purchased or sold or to whom securities are purchased or sold whether on a regular way, when issued, delayed or future delivery basis. It will also include any person for whom securities are held or carried and to or for whom a member extends, arranges or maintains any credit. The term will not include the following: (A) a broker or dealer from whom a security has been purchased or to whom a security has been sold for the account of the member or its customers…"
- Or Rule 4530, n. 08 regarding reporting requirements and customer complaints: "for purposes of paragraph (a)(1)(B) of this Rule, a 'customer' includes any person, other than a broker or dealer, with whom the member has engaged, or has sought to engage, in securities activities."

Is there a FINRA rule specifically defining customer for *arbitration* purposes? Indeed there is. For that we turn to Customer Code Rule 12200(i) which since April 2007 has defined "customer" for arbitration purposes thusly:

12100. Definitions

Unless otherwise defined in the Code, terms used in the Rules and interpretive material, if defined in the FINRA By-Laws, shall have the meaning as defined in the FINRA By-Laws…

(i) Customer

A customer shall not include a broker or dealer.

This of course is a very broad definition. At one point a glossary on the arbitration part of the FINRA web site defined "customer," but the definition is no longer there.[7] Also, thirty years ago the NASD's National Arbitration Committee – the predecessor to the FINRA's National Arbitration and Mediation Committee – issued an interpretive statement[8] that "[a]n issuer of securities should be considered a public customer of a member firm where a dispute arises out of a proposed underwriting," but it's anyone's guess whether that statement is still operative.

Summing up, while FINRA's rules do in places define the term "customer" these definitions are trumped by the specific arbitration rule that very broadly defines customer. This definition has given rise to litigation over its meaning.

The Courts Weigh In

This publication's prior article on the "who is a customer" issue described several cases that were in progress or subject to appeal. In the ensuing year and a half there has been lots of activity, with the Second and Fourth Circuits

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taking the lead. These cases have some common scenarios and fact patterns, which can be distilled as follows:

- The involved claimant/"customer" does not have a customer account with the broker dealer;
- The broker has some sort of business relationship with the customer: for example, the broker provided underwriting or advisory services to the institutional customer, or issued a product like bond funds that the customer purchased somewhere else, or recommended a financial adviser to the customer;
- A dispute arises and the customer files an arbitration under Rule 12200 (there being no underlying agreement containing a PDAA);
- Broker moves in court to enjoin[9] the arbitration contending that: 1) there is no agreement to arbitrate; and 2) Rule 12200 cannot be invoked because the claimant is not a "customer" as defined by the Customer Code.
- A court rules on whether the claimant is a "customer" whose "dispute arises in connection with the *business activities* of the member" who can invoke Rule 12200.

Let's take a look at the recent decisions, which have tended to focus on both core requirements of Rule 12200, that is: 1) was the party seeking arbitration a customer? and 2) does the dispute arise out of the broker's business activities?

Not a Customer:
The Morgan Keegan Cases

As a law professor, I like to boil holdings down to simple, easily remembered statements. A series of cases involving Morgan Keegan & Company ("MK") can be described succinctly: *"Just because they issued the fund doesn't make you their customer—unless MK signed a submission agreement and you argued this issue."* These cases have similar fact patterns:

- MK distributes and underwrites a bond fund.
- Investor buys the fund from another broker not affiliated with MK.
- Fund performs poorly.
- Investor suffers significant losses.
- Alleging fraud/misstatements/omissions, investor files an arbitration against MK, invoking Rule 12200.
- Contending the investor is not its customer MK resists, either by seeking a stay or attacking an adverse arbitration award.

This was the basic fact pattern in two cases decided in 2011 and 2012 where the challenge came as a motion to vacate an award. In *Zarecor v. Morgan Keegan,* 2011 WL 5592861 (E.D. Ark. 2011), *rev. den.,* 2011 WL 5508860 (E.D. Ark. 2011), the challenge came in the form of a motion to vacate an adverse award. The court found that the investor was not a customer as defined by Rule 12200. The investor sought reconsideration under Rule 59(e) of the Federal Rules of Civil Procedure, contending that the court overlooked a material fact: that MK had signed a submission agreement after the case was filed with FINRA.[10] The court denied the motion, because this argument had not been made earlier, and amounted to an attempt to introduce new evidence, something not permitted under Rule 59(e). It seems that, if the "MK signed a submission agreement" argument had been made originally (when the initial motion to vacate had been made), it might have succeeded.

This is precisely what happened in *Morgan Keegan & Company, Inc. v Garrett*, No. 11-20736 (5th Cir. 2012). There, the submission agreement issue was raised in the original motion to vacate and on appeal. While the district court held that the investor was not a customer of MK and vacated the award on this and other grounds – holding that the arbitrators had exceeded their powers under the Federal Arbitration Act (9 U.S.C sec. 10(a)(4)) by determining that the investors were customers – the Fifth Circuit reversed, relying in part on the submission argument. In other words, the Rule 12200 "is this a customer?" issue was mooted because MK had agreed to submit to arbitration after the dispute arose. However, the court also disposed of the "customer" issue by holding that MK had not met the very high bar set by the Federal Arbitration Act for vacating an award based on the arbitrators exceeding their powers. This case can be distinguished from those discussed below because it dealt with a motion to vacate the arbitration award, which is extraordinarily difficult to win and in which courts give great deference to the arbitrators.

So, assuming MK did not sign a submission agreement and instead contested jurisdiction from the beginning by seeking to enjoin the arbitration, what do the cases tell us? It seems then that the investor is decidedly *not* a customer under Rule 12200. In two district court cases in 2011, *Morgan Keegan & Co., Inc. v. Ras,* No. 5:11-CV-352-KKC (E.D. Ky. 2011) and *Morgan Keegan & Co. v. Shadburn*, 829 F.Supp.2d 1141 (M.D. Ala. 2011), the district courts ruled that in the absence of a customer agreement, or a customer account, or evidence that the funds were purchased directly from MK, or other evidence of a business relationship between the investor and MK, the investor was not a customer of MK who could require arbitration under Rule 12200. This was the case even though the investor's broker may have had conversations with MK.

The result does not vary at the Circuit Court level. Earlier this year the Fourth Circuit reached the same conclusion in *Morgan Keegan & Co., Inc. v. Silverman,* --- F.3d ---, 2013 WL 425556 (2013).

A Question of Balance

While it seems clear what *won't* qualify a claimant as a customer under Rule 12200, what factors are enough to successfully attain "customer" status under this rule? A pattern has emerged from recent federal circuit court decisions. The reviewing court will balance the strong federal policy in favor of liberally construing arbitration agreements articulated many times by the Supreme Court[11] versus whether there actually is an agreement to arbitrate by virtue of Rule 12200. Where there is clear evidence of a direct customer relationship with the broker

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and the dispute clearly arises out of the broker's securities business activities, arbitration will be ordered. Where the relationship is tenuous or does not arise clearly out of the broker's securities business, arbitration will not be ordered. Or, to sum it up for my law students: *"To be considered a customer, you need clear evidence of a direct, significant securities business relationship."*

Not Enough: Innovex *and* Cary

The seminal case, and one that is referred to in the more recent decisions, is *Fleet Boston v. Innovex,* 264 F.3d 770 (8th Cir. 2001), which sets the outer limit on defining Rule 12200.[12] There the broker provided "banking and financial advice" to the putative customer concerning its planned merger. The agreement between the parties specifically did not call for Fleet Boston to act as a broker for the "customer." Applying the balancing test, the court said there was not enough of a relationship present to establish customer status:

> We do not believe that the NASD [now FINRA] Rules were meant to apply to every sort of financial service an NASD member might provide, regardless of how remote that service might be from the investing or brokerage activities, which the NASD oversees…. Although not entirely clear, or consistent, other NASD Rules support a general definition of "customer" as one who receives investment and brokerage services or otherwise deals more directly with securities than what occurred here.

The Fourth Circuit very recently came to the same conclusion in *Raymond James Financial Services v. Cary,* 709 F.3d 382 (4th Cir. Mar. 18, 2013). The facts are a bit convoluted, but they come down to this: the investors bought unregistered promissory notes from Innofin, which most decidedly was not a FINRA member. The wife of a registered rep, Keough (who ultimately worked at Raymond James), received referral fees from Innofin. She shared these fees with Affeldt, described by the court as "Keough's friend, brokerage customer, and tax attorney." Innofin eventually declared bankruptcy and was accused of operating a Ponzi scheme. The investors then commenced an arbitration under Rule 12200 against Raymond James, which succeeded in having the district court enjoin the arbitration. On appeal, the Fourth Circuit affirmed, finding too tenuous the connection between the investors and Raymond James' securities business:

> Although FINRA itself provides no precise definition of "customer" as used in Rule 12200, our recent decisions …have defined that term to mean "an entity that is 'not a broker or dealer, who purchases commodities or services from a FINRA member in the course of the member's business activities,' namely, 'the activities of investment banking and the securities business.'" … Applying that definition to the facts of this case, we conclude that appellants are not RJFS customers because they did not purchase any "commodities or services" from RJFS or Keough in the course of the firm's business activities. Any connection appellants did have to RJFS by virtue of their dealings with Affeldt is far too remote to make them customers of RJFS.

There was no customer agreement, no account, and of key importance no assertion that the investors ever believed they were dealing with Raymond James. Applying the balancing test, the Court found no arbitration agreement created by Rule 12200 for it to liberally construe under the Federal Arbitration Act.

Enough: West Virginia Hospitals *and* Carilion Clinic

What, then, is enough to create a "customer" under Rule 12200? Two recent circuit court decisions are shaping an answer to this question. In the first case, *UBS Financial Services, Inc. v. West Virginia University Hospitals, Inc.,* 660 F.3d 643 (2d Cir. 2011), FINRA member UBS provided underwriting and brokerage services for a fee to the hospital, in connection with its issuance of auction rate securities ("ARS") to finance the renovation and expansion of the hospital and to restructure debt. After the ARS market collapsed in 2008, the hospital had to pay much higher interest rates on its ARS. Eventually, the hospital started an arbitration under Rule 12200, and UBS sought declaratory relief that the hospital was not a customer. The district court held that "FINRA intended for an issuer to be a customer of an underwriter."[13] On appeal, the Second Circuit affirmed.

The Court found that the hospital clearly was UBS' customer ("[the hospital] was UBS' customer because [it] purchased a service, specifically auction services, from UBS") and that the dispute arose in connection with UBS' business activities.

> Under any conceivable interpretation of Rule 12200's nexus requirement that the dispute "arises in connection with the business activities of the member," the allegations here satisfy the requirement for purposes of defeating a motion for preliminary injunction and link the grievance [the hospital] asserts in arbitration to the transaction that established its customer status.

Applying the balancing test here, the Court found enough present for it to liberally construe the arbitration agreement created by Rule 12200.

Saving the best for last, let's examine *UBS Financial Services, Inc. v. Carilion Clinic,* No. 12-2066 (4th Cir. Jan. 23, 2013). This was another ARS case involving an underwriter and an issuer, with a fact pattern very similar to *West Virginia*, including a district court ruling that the issuer was a customer under Rule 12200. The Fourth Circuit affirmed, distinguishing the facts here from *Innovex* ("the court [there] was faced with a purported customer who had merely received financial advice…"). It embraced a plain English definition of customer, citing *Merriam-Webster's Collegiate Dictionary* ("one that purchases a commodity or service"), and adopted the definition articulated by the Second Circuit in *West Virginia:*

> In short, we conclude that "customer," as that term is used in the FINRA Rules, refers to one, not a broker or

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> a dealer, who purchases commodities or services from a FINRA member in the course of the member's business activities insofar as those activities are regulated by FINRA—namely investment banking and securities business activities.

The Fourth Circuit two weeks later affirmed this definition in *Silverman* and a month after that in *Cary* (both discussed above). Applying the balancing test here led the court to liberally construe the arbitration agreement created by Rule 12200, and to allow the arbitration filed by the putative customer to proceed..

Time to Clear Up the Confusion: a Proposal

In some respects this reminds me of the time following passage of the Americans with Disabilities Act. The term "reasonable accommodation" was very broadly defined by Congress. This gave rise to years of litigation and uncertainty over what that term meant.[14] I suggest that FINRA start the process now to give clarity to the arbitration customer definition. Yes, the courts are slowly resolving the issue, but the process can take a long time and can be fraught with uncertainty.[15] And with the possibility that PDAAs will be banned and Rule 12200 will become the only realistic path to FINRA arbitration for customers, the time to act is now.

I propose that FINRA consider adopting the arbitration customer definition articulated by the Fourth Circuit in Carilion, Silverman and Cary. With minor editing by the author, the definition becomes:

> "Customer" as that term is used in the FINRA Code of Arbitration Procedure for Customer Disputes refers to one, not a broker or a dealer, who purchases commodities or services from a FINRA member in the course of the member's business activities insofar as those activities are regulated by FINRA—namely investment banking and securities business activities.

This is a nice, simple, clear definition. Enhancing investor protection – FINRA's core mission – and, for that matter, clearing up the ambiguity for the broker-dealers that FINRA regulates, dictate that the lack of clarity be addressed.

ENDNOTES

[1] Addressing the North American Securities Administrators Association on Apr. 16, 2013. See http://www.sec.gov/news/speech/2013/spch041613laa.htm <visited Apr. 21, 2013>. The reference to Commissioner Aguilar's statement is a premise that supports the author's proposition. Using it does not mean that the author necessarily agrees with Mr. Aguilar's position. While the author believes action will be critical if PDAAs are banned, he also believes that FINRA, the industry, and the investing public would be best served by a more precise definition, irrespective of whether the SEC bans the PDAA, directs modifications and restrictions on its use, or decides ultimately that the public interest is well-served by maintaining the status quo.

[2] Dodd-Frank section 921(b) gives SEC similar authority to address PDAAs in investment adviser agreements with customers.

[3] Beyond the scope of this article and for another day is addressing such sticky issues as retroactivity.

[4] *See,* Gross, J., *The End of Mandatory Arbitration?* 30:5 PACE L. REV. 1174, 1189-93 (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1669816 <visited May 5, 2013>.

[5] FINRA Rule 12200, available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4106 <visited May 5, 2013>.

[6] See this statement appearing on the FINRA web site: "If the SEC decides to prohibit or limit mandatory arbitration, FINRA believes that it is vital for investor protection that FINRA's rules continue to permit investors to require arbitration with firms and associated persons. Specifically, FINRA believes that, whatever position the SEC takes on mandatory arbitration, it is critical that FINRA's Customer Code Rule 12200, which empowers investors to require arbitration with their broker, be maintained." http://www.finra.org/web/groups/industry/@ip/@edu/@mat/documents/education/p123609.pdf <visited May 5, 2013>.

[7] See http://www.finra.org/arbitrationandmediation/finradisputeresolution/additionalresources/glossary/ <visited May 5, 2013>.

[8] *See, UBS Fin. Svcs. Inc. v, West Virginia Univ. Hosps., Inc.,* 660 F.3d 643, 653 (2d Cir. 2011),

[9] Waiting until an award is issued, and fashioning the challenge as a motion to vacate the award based on the arbitrator exceeding authority, can lead to disappointment for the challenger. *See, Morgan Keegan & Co., Inc. v, Garrett,* No. 11-20736 (5th Cir. 2012), discussed above. There, the firm challenged the award, contending among other bases that the arbitrators had erroneously concluded that investors who bought Morgan Keegan bond funds from a third-party broker in the secondary market were "customers." This was successful at the district court level, but failed at the 5th Circuit Court of Appeals. An old proverb says "It is much easier to seek a stay of arbitration than it is an award vactur."

[10] This is standard operating procedure under the Customer Code.

[11] Citing, for example, *Moses H. Cone Mem'l. Hosp. v. Mercury Constr. Corp.,* 460 U.S. 1, 24-25 (1983), *Volt Info. Sciences, Inc. v. Stanford,* 489 U.S. 468, 478 (1989); *CompuCredit Corp. v. Greenwood,* 132 S.Ct. 665, 669 (2012), and *AT&T Mobility LLC v. Concepcion,* 131 S. Ct. 1740, 1745 (2011).

[12] The case actually dealt with the predecessor NASD Rule.

[13] 760 F.Supp.2d at 378 (S.D.N.Y. 2010).

[14] See, for example, the exhaustive list in U.S. E.E.O.C., *Enforcement Guidance: Reasonable Accommodation: and Undue Hardship under the ADA,* available at http://www.eeoc.gov/policy/docs/accommodation.html <visited Apr. 20, 2013>.

[15] Meanwhile, the court challenges keep coming. The Southern District is now dealing with whether a hedge fund that purchased mortgage-backed securities via its broker may arbitrate under Rule 12200 against the issuer. *See, SunTrust Banks, Inc. v. Turnberry Capital Management LP,* No. 13-879 (S.D.N.Y. Feb. 5, 2013). In the District Court of Maryland, a new Complaint has been filed by Credit Suisse, challenging the "customer" status of a group of more than 30 investors who invested in an ETN (TVIX) product issued by the brokerage firm. *Credit Suisse Securities (USA) LLC v. VLS Securities LLC,* No. 13-1187 (D. Md. 4/22/13). Finally, as we headed to press, a NY federal court completed a 9-day trial to decide whether a Saudi investor, who entered into complex investinvestment transactions with Ctiigroup, was a "customer" under Rule 12200 and could maintain is case in FINRA arbitration. In a 14-page Opinion, the Court granted Citigroup injunctive relief staying FINRA arbitration. *CGMI v. Abbar,* No. 11-06993 (SDNY 5/2/13), citing with favor the "customer" definitions articulated in *West Virginia, Silverman* and *Carilion.*