

# Defining “Customer”: A Survey of Who Can Demand FINRA Arbitration

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# Defining “Customer”: A Survey of Who Can Demand FINRA Arbitration

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## INTRODUCTION

Over the past 20 years, courts and legislators have limited the rights of plaintiffs to assert securities claims in federal courts in response to complaints about abusive litigation.<sup>1</sup> The prosecution of securities claims has grown more difficult as the Supreme Court has

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1. See Richard Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1, 32 (1998) (describing the “battle” over the merits of securities lawsuits where “plaintiffs’ lawyers accuse issuers, underwriters, and accountants of pervasive fraud, and they, in turn, charge plaintiffs’ lawyers with greed and opportunism”). Critics of the private right of action under the federal securities laws have contended that these cases are time-consuming and expensive, only transfer wealth between shareholders, and are often merely strike suits that do not benefit shareholders. See Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 546 (1991) (stating that “[s]ecurities cases are large, complex and expensive to litigate, and take a long time to resolve” and finding that class actions generally took from 43 to 68 months from filing to settlement approval and a single case could cost over \$1 million for the plaintiff to litigate (footnote omitted)); Richard A. Booth, *The Future of Securities Litigation*, 4 J. BUS. & TECH. L. 129, 143–44 (2009) (arguing that securities fraud class actions “suffer from circularity” because “(1) the costs fall on the corporation and thus its stockholders (even though the company gained nothing from the fraud), (2) settlements account for a very small percentage of total investor losses, and (3) the settlement is effectively paid by investors who held shares at the time of the fraud to investors who bought during the fraud period” and suggesting that securities class actions should be brought derivatively (footnote omitted)); Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533, 533 (1997) (“One of the most damaging accusations made against class action litigation, particularly securities litigation, is the claim that it is ‘lawyer-driven litigation.’ In the parlance of, among others, the proponents of the Republican Contract with America, lawyer-driven litigation is inherently abusive.” (footnotes omitted)).

chipped away at the private right of action.<sup>2</sup> Similarly, Congress has passed a series of laws targeted at raising the pleading bar for plaintiffs in securities actions<sup>3</sup> and forcing large securities cases into federal court.<sup>4</sup>

While litigating securities claims has become more difficult for plaintiffs, a rise in the use of pre-dispute arbitration agreements (PDAAs) has led to a significant growth in securities arbitration under the auspices of the National Association of Securities Dealers

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2. See, e.g., *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) (barring private plaintiffs from asserting claims for aiding and abetting securities fraud); *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 338 (2005) (raising the pleading standards for loss causation in private securities actions); *Stoneridge Inv. Partners v. Scientific-Atlanta*, 552 U.S. 148, 159–60 (2008) (barring private plaintiffs from asserting claims against third-party actors under a “scheme liability” theory).

3. In 1995, Congress passed the Private Securities Litigation Reform Act (PSLRA), Pub. L. No. 104-67, 109 Stat. 737. The explicit goal of the PSLRA was to “protect investors, issuers, and all who are associated with our capital markets from abusive securities litigation.” H.R. REP. NO. 104-369, at 32 (1995) (Conf. Rep.), reprinted in 1995 U.S.C.C.A.N. (104 Stat.) 730, 731. See Matthew O’Brien, *Choice of Forum in Securities Class Actions: Confronting “Reform” of the Securities Act of 1933*, 28 REV. LITIG. 845, 858 (2009) (“In particular, Congress wanted the PSLRA to curtail ‘strike suits’—‘meritless class actions alleging fraud in the sale of securities . . . .’” (footnote omitted)). Among other provisions, the PSLRA instituted a mandatory stay of discovery until after the resolution of an initial motion to dismiss, 15 U.S.C. § 77z-1(b) (2012), and greatly increased the pleading burden for plaintiffs by requiring a particularized pleading of misrepresentations and scienter. *Id.* § 78u-4(b).

4. In 1998, in response to concerns that plaintiffs were avoiding the PSLRA by filing lawsuits in state court, Congress passed the Securities Litigation Uniform Standards Act (SLUSA). See H.R. REP. NO. 105-803, at 2 (1998) (Conf. Rep.) (“[I]n order to prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the Private Securities Litigation Reform Act of 1995, it is appropriate to enact national standards for securities class action lawsuits involving nationally traded securities, while preserving the appropriate enforcement powers of State securities regulators and not changing the current treatment of individual lawsuits.”). SLUSA prevents securities class actions from proceeding in state court and prevents parties from asserting class actions alleging violations of state securities laws. See *Segal v. Fifth Third Bank, N.A.*, 581 F.3d 305, 309 (6th Cir. 2009) (“After PSLRA became law, some claimants responded by ‘avoid[ing] the federal forum altogether,’ bringing ‘class actions under state law, often in state court’ instead. That apparently was not what Congress had in mind. In 1998, it sought to close the gap in coverage by enacting SLUSA. To ‘prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of’ PLSRA, SLUSA expressly prohibits certain state law class actions. . . .” (internal citations omitted) (quoting *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 82 (2006)). See generally William B. Snyder, Jr., *The Securities Act of 1933 after SLUSA: Federal Class Actions Belong in Federal Court*, 85 N.C. L. REV. 669, 676–77 (2007).

(NASD) and its successor, the Financial Industry Regulatory Agency (FINRA), the self-regulatory authorities that oversee the securities industry and its arbitral forum.<sup>5</sup> At the same time that courts were raising the bar for securities litigation, FINRA altered its own rules to make the forum more attractive to investors.<sup>6</sup> Not surprisingly, in recent years a fair amount of litigation has arisen around the issue of arbitrability, in which securities industry members seek to deny plaintiffs access to FINRA’s arbitral forum and force plaintiffs to bring their claims in court.<sup>7</sup>

FINRA arbitration is available to any customer of a FINRA member for any claim that arises out of that member’s business activities, either based upon a written agreement between the parties

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5. See Catherine Moore, *The Effect of the Dodd-Frank Act on Arbitration Agreements: A Proposal for Consumer Choice*, 12 PEPP. DISP. RESOL. L. J. 503, 511 (2012) (“[W]hile the investment market has expanded, the number of arbitration forums has shrunk to one—FINRA. Thus, there are more consumers signing predispute arbitration agreements and only one forum in which they can settle their disputes.” (footnote omitted)).

6. Two recent pro-customer changes to FINRA rules include allowing customers to request an all-public arbitration panel, which does not include an industry representative and also limiting motions to dismiss prior to the arbitration hearing. See *Optional All Public Panel Rule* FINRA R. 12403(c)(1)(A) (2013), available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=4141](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4141) (“Rule 12403 . . . provides for limited strikes on the public and public chairperson lists and unlimited strikes on the non-public list. In optional all public panel cases, the panel may consist of three public arbitrators or two public arbitrators and one non-public arbitrator. Under this option, either party can ensure that the panel will have three public arbitrators by striking all of the arbitrators on the non-public list.”) The *Optional All Public Panel Rule* went into effect on January 31, 2011. See *Optional All Public Panel Rules*, FINRA, <http://www.finra.org/arbitrationandmediation/arbitration/rules/ruleguidance/noticestoparties/p123997>; see also FINRA R. 12504(a) (2013), available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=7377](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=7377); News Release, FINRA, SEC Approves FINRA Rule to Drastically Limit Motions to Dismiss in Arbitration (Jan. 8, 2009), available at <http://www.finra.org/Newsroom/NewsReleases/2009/P117686> (“By narrowing significantly the grounds for granting dispositive motions before investors present their case, the new rule will ensure that claimants in arbitration have a full opportunity to argue their case. Under the new rule, a motion to dismiss before a claimant’s case is presented can only be granted on three specific grounds, and there are stringent new sanctions against parties for engaging in abusive case-dismissal practices.”). FINRA Rule 12405 went into effect on February 23, 2009.

7. See Barbara Black, *The Irony of Securities Arbitration Today: Why Do Brokerage Firms Need Judicial Protection?*, 72 U. CIN. L. REV. 415, 416, 419–31 (2003) (outlining situations in which FINRA members have gone to court to enjoin arbitration). “Illustrating a classic example of ‘be careful what you wish for,’ brokerage firms no longer find arbitration entirely to their liking. Increasingly they turn to the courts to resist arbitration, to interfere with ongoing arbitration, or to undo the results of arbitration.” *Id.*

or the customer's demand.<sup>8</sup> Many investors have PDAs with their brokerage firms, binding them to FINRA arbitration of their claims.<sup>9</sup> But for plaintiffs who do not have PDAs or who seek to assert claims against FINRA members other than their brokers, FINRA rules grant them the option of arbitration at their choosing but only if they are a customer of the member.<sup>10</sup> Remarkably, given the broad nature of this right to arbitrate, FINRA has made almost no attempt to define "customer" as used in its rules.<sup>11</sup> Accordingly, courts have been forced to wrestle with the definition on a case-by-case basis with disparate results and resulting confusion about which claimants are entitled to arbitrate.<sup>12</sup>

Debating the proper definition of a FINRA "customer" is not merely a theoretical or academic exercise. Greater urgency may soon arise around this issue given that The Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act) expressly grants the SEC authority to bar the use of PDAs in brokerage agreements.<sup>13</sup> If the SEC exercises this authority to bar PDAs,

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8. FINRA R. 12200 (2013), available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=4106](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4106).

9. See Barbara Black, *How to Improve Retail Investor Protection After the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 13 U. PA. J. BUS. L. 59, 61 (2010) ("Currently, virtually all broker-dealers include in their customers' agreements a predispute arbitration agreement (PDA) that requires customers to arbitrate their disputes before the Financial Industry Regulatory Authority (FINRA) arbitration forum." (footnote omitted)).

10. FINRA R. 12200.

11. The only definition of "customer" that FINRA provides within its Arbitration Code is that it "shall not include a broker or dealer." FINRA R. 12100(i) (2013), available at [http://finra.complinet.com/en/display/display.html?rbid=2403&record\\_id=15138&element\\_id=4099&highlight=12100%28i%29](http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=15138&element_id=4099&highlight=12100%28i%29). See discussion *infra* Section III.

12. See discussion *infra* Sections III, IV.

13. See 15 U.S.C. § 78o(o). As stated:

Authority to restrict mandatory pre-dispute arbitration: The Commission, by rule, may prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of any broker, dealer, or municipal securities dealer to arbitrate any future dispute between them arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors.

*Id.* Recently, the SEC Commissioner and 37 members of Congress have urged the SEC to exercise this discretion and bar pre-dispute arbitration agreements. See Sarah N. Lynch, *Lawmakers Urge U.S. SEC to Bar Forced Wall Street Arbitration*, REUTERS, Apr. 30, 2013, available at <http://www.reuters.com/article/2013/04/30/congress-sec-arbitration-idUSL2N0DH1VZ20130430>; Luis A. Aguilar, Comm'r, U.S. Sec. Exch. Comm'n, *Outmanned and Outgunned: Fighting on Behalf of Investors Despite Efforts to Weaken Investor Protections*

securities arbitration for investors would revert to a largely optional system, available at the customers’ elections. Given the broad differences in procedural and substantive rules applicable to litigation and FINRA arbitration<sup>14</sup>—which may even include additional substantive causes of action for arbitral claimants<sup>15</sup>—an entirely optional system would grant significant advantages to investor–plaintiffs and excite further attention upon who is a customer entitled to demand arbitration. The current legal morass on this issue, in which courts have espoused several disparate definitions of “customer” in resolving cases, provides little guidance to parties about whether claims are properly asserted in arbitration.

This Article begins with two background sections. Section I provides background on FINRA, the regulatory authority overseeing the securities industry. Section II delves into FINRA arbitration with a particular focus on Rule 12200, which grants customers a unilateral right to demand arbitration. In Section III, this Article surveys the case law on arbitrability across a number of fact patterns to demonstrate the current state of the law on the definition of “customer” as it pertains to FINRA arbitration. In Section IV, this Article analyzes how courts have reached the current state of the law by considering four theories of “customer” that courts have relied on in deciding cases. Finally, in conclusion, the authors argue for a definition of “customer” consistent with the term’s ordinary meaning and the scope of FINRA regulation to provide broad access to the FINRA forum for customers who have direct and regulated relationships with FINRA members.

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(Apr. 16, 2013), *available at* <http://www.sec.gov/News/Speech/Detail/Speech/1365171515400>) (“[M]y main concern with *pre-dispute* mandatory arbitration is the denial of investor choice; investors should not have their option of choosing between arbitration and the traditional judicial process taken away from them at the very beginning of their relationship with their brokers and advisers . . . . I believe the Commission needs to be proactive in this important area. We need to support investor choice.”); Letter from 37 congressmen to Mary Jo White, Comm’r, U.S. Sec. Exch. Comm’n (Apr. 30, 2013), *available at* [http://www.franken.senate.gov/?p=press\\_release&id=2381](http://www.franken.senate.gov/?p=press_release&id=2381) (“The exigent circumstances at hand, however, require that the Commission exercise its authority under Section 921 of the Dodd-Frank Act and prohibit the use of mandatory arbitration provisions.”).

14. *See infra* notes 52–56 and accompanying text.

15. *See infra* note 57 and accompanying text.

## I. FINRA REGULATES THE SECURITIES INDUSTRY

FINRA is the comprehensive, self-regulatory organization (SRO) governing the securities industry.<sup>16</sup> FINRA was established under § 15A of the Securities Exchange Act of 1934 (Exchange Act), which requires the formation of a “national securities association” to regulate the securities industry.<sup>17</sup> Although overseen by the SEC,<sup>18</sup> FINRA is an independent body given broad powers to police the industry in order “to protect investors and the public interest.”<sup>19</sup> As FINRA describes on its website:

We examine broker-dealers for compliance with our own rules; we also examine them for compliance with federal securities laws and rules of the Municipal Securities Rulemaking Board. . . . FINRA is not part of the government. We are an independent regulator authorized by Congress to take action to ensure that investors are protected. We do the front-line work for the SEC under that

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16. See FINRA, GET TO KNOW US i (2012), available at <http://www.finra.org/web/groups/corporate/@corp/@about/documents/corporate/p118667.pdf> (“FINRA is the Financial Industry Regulatory Authority. We’re an independent, not-for-profit organization with a public mission: to protect America’s investors by making sure the securities industry operates fairly and honestly. . . . Our independent regulation plays a critical role in America’s financial system—by enforcing high ethical standards, bringing the necessary resources and expertise to regulation and enhancing investor safeguards and market integrity . . .”).

17. 15 U.S.C. § 78o-3(b)(2) (2012). In 1938, the Maloney Act amended the Exchanged Act to permit broker-dealers to create a self-regulatory organization to oversee the securities industry. Maloney Act of 1938, Pub. L. No. 75-719, 52 Stat. 1070 (1938).

18. Pursuant to the Maloney Act, any self-regulatory organization regulating the securities industry is required to file an application for registration with the SEC that includes the association’s rules. 15 U.S.C. § 78o-3(a) (2012). Thereafter, the organization is required to obtain SEC approval for any changes to the organization’s rules. *Id.* § 78s(b).

19. *Id.* § 78o-3(b)(6). The Exchange Act requires that the “national securities association” pass rules to regulate the industry to achieve certain goals. See *id.* As stated:

The rules of the association are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, 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.*

agency’s oversight. If brokers break the rules, we can fine them, suspend them and even put them out of business.<sup>20</sup>

FINRA was created in 2007 through the consolidation of the NASD and New York Stock Exchange Regulation, Inc. (NYSE Regulation), the regulatory arm of the New York Stock Exchange LLC.<sup>21</sup> Prior to the consolidation, the NASD and NYSE Regulation operated separate regulatory departments, which often resulted “in a duplicative, sometimes conflicting system that makes inefficient use of resources and, as such, can be detrimental to the ultimate goal of investor protection.”<sup>22</sup> Having one SRO responsible for regulating the securities industry streamlined regulatory review, thereby benefitting not only member firms but also better protecting investors.<sup>23</sup> FINRA, as the newly formed joint entity, became “responsible for regulatory oversight of all securities firms that do business with the public.”<sup>24</sup>

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20. *About FINRA*, FINRA, <http://www.finra.org/AboutFINRA/P125239> (last visited Sept. 5, 2013).

21. *See* Release, Sec. & Exch. Comm’n, S.E.C. Release No. 34-55495, Notice of Filing of Proposed Rule Change Related to Governance and to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc. 1–2 (Mar. 20, 2007) [hereinafter Notice of Filing Proposed Rule Change], *available at* <http://www.sec.gov/rules/sro/nasd/2007/34-55495.pdf>; Release, Sec. & Exch. Comm’n, S.E.C. Release No. 34-56145, Order Approving Proposed Rule Change Related to Governance and to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc., 1 (July 26, 2007) [hereinafter Order Approving Proposed Rule Change], *available at* <http://www.sec.gov/rules/sro/nasd/2007/34-56145.pdf>. For a general discussion on the formation of FINRA and its predecessor, NASD, *see* Wachovia Bank, Nat. Ass’n v. VCG Special Opportunities Master Fund, Ltd., 661 F.3d 164, 172–73 (2d Cir. 2011); Roney & Co. v. Goren, 875 F.2d 1218, 1221–22 (6th Cir. 1989); Black, *supra* note 9, at 63–64.

22. *See* Notice of Filing Proposed Rule Change, *supra* note 21, at 2.

23. *See id.* at 9 (“[F]irms that today are regulated by both NASD and NYSE Regulation will benefit from the elimination of the current duplication of regulatory review of these firms. . . . [Having one SRO] will further benefit members as it will streamline the broker-dealer regulatory system, combine technologies and permit the establishment of a single set of rules and group examiners with complementary areas of expertise in a single organization—all of which will serve to enhance oversight of U.S. securities firms and help to ensure investor protection.”).

24. *See* Order Approving Proposed Rule Change, *supra* note 21, at 3; *see also* UBS Fin. Servs., Inc. v. W. Va. Univ. Hosps., Inc., 660 F.3d 643, 648 (2d Cir. 2011) (noting that FINRA “has had the authority to exercise comprehensive oversight over ‘all securities firms that do business with the public’” (quoting *Sacks v. SEC*, 648 F.3d 945 (9th Cir. 2011))).



Membership in FINRA is essentially mandatory to participate in the securities industry.<sup>25</sup> Any broker<sup>26</sup> or dealer<sup>27</sup> who wishes to transact in securities must register with FINRA unless they transact solely through a national securities exchange, in which case they must register through the exchange.<sup>28</sup> Because FINRA was formed by the merger of the NASD with the NYSE, the nation's largest national securities exchange, effectively all but a vanishingly few securities firms are registered with FINRA.<sup>29</sup> Once a firm is registered, its officers, partners, and supervisory managers must register with FINRA as principals,<sup>30</sup> and any persons actively involved in the firm's securities business must register with FINRA

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25. See Release, Sec. & Exch. Comm'n, S.E.C. Release No. 34-50700, Concept Release Concerning Self-Regulation 2 (Nov. 28, 2004), available at <http://www.sec.gov/rules/concept/34-50700.htm> ("Self-regulation is a key component of U.S. securities industry regulation. All broker-dealers are required to be members of a self-regulatory organization ("SRO"), which sets standards, conducts examinations, and enforces rules regarding its members."). For an overview of the history of arbitration agreements in securities disputes, see Moore, *supra* note 5, at 507–24.

26. "Broker" is defined by the Exchange Act as "any person engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C. § 78c(a)(4)(A) (2012).

27. "Dealer" is defined by the Exchange Act as "any person engaged in the business of buying and selling securities . . . for such person's own account through a broker or otherwise." *Id.* § 78c(a)(5)(A). There is an exception written into the rule for persons that buy or sell securities for their own account but "not as part of a regular business," which exempts ordinary investors from FINRA regulation so long as their trading of securities is not a regular business. *Id.* § 78c(a)(5)(B).

28. Under § 15(a) of the Exchange Act, it is illegal for any broker or dealer to transact or attempt to transact in any security, with few exceptions, unless the broker-dealer is registered with either a registered securities association or with a national securities exchange—in which case the broker or dealer must only transact in securities through that exchange. *Id.* §§ 78o(b)(1), (8). The exceptions are for exempted securities, commercial paper, bankers' acceptances, and commercial bills. *Id.* § 78o(a)(1). Presently, FINRA is the only registered securities association recognized by the SEC. See *Self-Regulatory Organization Rulemaking*, U.S. SEC, <http://www.sec.gov/rules/sro.shtml> (last visited Oct. 21, 2013).

29. See Christopher Cox, Chairman, U.S. Sec. Exch. Comm'n, Statement at News Conference Announcing NYSE–NASD Regulatory Merger (Nov. 28, 2006), available at <http://www.sec.gov/news/speech/2006/spch112806cc.htm> (announcing that merger would create "a single self regulator for all firms in the securities industry."); see also GET TO KNOW US, *supra* note 16, at 3 ("Every firm and broker that sells securities in the U.S. must be licensed and registered by FINRA: 4,400 securities firms, 163,000 branch offices, [and] 630,000 registered securities representatives.").

30. FINRA R. 1021(b) (2013), available at [http://finra.complinet.com/en/display/display.html?rbid=2403&record\\_id=4254&element\\_id=3579&highlight=1021%28b%29](http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=4254&element_id=3579&highlight=1021%28b%29).

as representatives.<sup>31</sup> Effectively, then, FINRA’s regulatory scope includes any firm or individual who transacts business in securities either for its own account or for the account of another.<sup>32</sup>

By becoming a FINRA member, entities gain the right to operate a business trading securities, but they also gain regulatory requirements and obligations to the larger investing public and their customers under FINRA Rules.<sup>33</sup> As discussed in the next Section, one of those rules includes mandatory submission to arbitration when demanded by a customer.

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31. FINRA R. 1031(b) (2013), *available at* [http://finra.complinet.com/en/display/display.html?rbid=2403&record\\_id=4260&element\\_id=3584&highlight=1031](http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=4260&element_id=3584&highlight=1031).

32. FINRA’s overall “Objects or Purposes” are discussed in its Restated Certificate of Incorporation and include:

- (1) To promote through cooperative effort the investment banking and securities business, to standardize its principles and practices, to promote therein high standards of commercial honor, and *to encourage and promote among members observance of federal and state securities laws*;
- (2) To provide a medium through which its membership may be enabled to confer, consult, and cooperate with governmental and other agencies in the solution of problems affecting investors, the public, and the investment banking and securities business;
- (3) To adopt, administer, and enforce rules of fair practice and rules to prevent fraudulent and manipulative acts and practices, and in general *to promote just and equitable principles of trade for the protection of investors*;
- (4) To promote self-discipline among members, and *to investigate and adjust grievances between the public and members and between members . . . .*

*Restated Certificate of Incorporation of Financial Industry Regulatory Authority, Inc.*, FINRA (July 2, 2010), [http://finra.complinet.com/en/display/display.html?rbid=2403&element\\_id=4589](http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=4589) (emphasis added). One significant part of the investment industry that is not currently regulated by FINRA is investment advisors who are covered by the Advisors Act. Recent concerns about regulation of investment advisors in light of the Bernie Madoff scandal has attracted congressional attention and led to the possibility of establishing self-regulatory organization oversight of investment advisors, an industry FINRA has expressed a willingness to cover. See Kirill Kan, *The Importance of FINRA’s Arbitrator Selection Process and Clarity in the “Evident Partiality” Standard in the Wake of Morgan Keegan*, 18 FORDHAM J. CORP. & FIN. L. 167, 172 (2012) (describing proposed Investment Adviser Oversight Act and noting that “FINRA has already voiced its willingness to assume responsibility for this newly created SRO, which would regulate investment advisers.” (footnote omitted)). Accordingly, FINRA’s regulatory scope may expand further in the coming years.

33. See *UBS Fin. Servs., Inc. v. W. Va. Univ. Hosps., Inc.*, 660 F.3d 643, 648 (2d Cir. 2011) (“Upon joining FINRA, a member organization agrees to comply with FINRA’s rules.”); *Id.* at 649 (“As a FINRA member, therefore, UBS is bound to adhere to FINRA’s rules and regulations, including its Code and relevant arbitration provisions contained therein.”).

## II. FINRA ARBITRATION IS AVAILABLE TO “CUSTOMERS” OF FINRA MEMBERS

In addition to its regulatory and enforcement arms, FINRA provides a dispute-resolution forum for disputes arising between members and their customers or between members.<sup>34</sup> FINRA oversees approximately 90% of all arbitrations of securities disputes.<sup>35</sup> FINRA has two separate codes of arbitration procedure that provide the rules for the arbitral forum.<sup>36</sup> The Customer Code governs arbitration between members of FINRA and their customers, and the Industry Code provides rules for disputes between or among FINRA members only.<sup>37</sup>

Since the Supreme Court’s 1987 decision in *Shearson/American Express, Inc. v. McMahon*<sup>38</sup> and its 1989 decision in *Rodriguez de Quijas v. Shearson/American Express, Inc.*,<sup>39</sup> which cleared the way for pre-dispute arbitration clauses in securities account agreements, most FINRA customer arbitrations are compelled by the customer’s agreement.<sup>40</sup> But beginning in 1973, FINRA’s rules, as well as the

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34. See *Arbitration & Mediation*, FINRA, <http://www.finra.org/arbitrationandmediation/index.htm> (last visited Sept. 5, 2013) (“FINRA operates the largest dispute resolution forum in the securities industry to assist in the resolution of monetary and business disputes between and among investors, brokerage firms and individual brokers.”).

35. DAVID E. ROBBINS, *SECURITIES ARBITRATION PROCEDURE MANUAL* xiv (5th ed. 2005) (“NASD Dispute Resolution, Inc. now administers 95% of all securities arbitrations.”).

36. See *Code of Arbitration Procedure*, FINRA, <http://www.finra.org/arbitrationandmediation/arbitration/rules/codeofarbitrationProcedure/> (last visited Sept. 5, 2013).

37. See *id.*

38. 482 U.S. 220, 227 (1987) (holding that pre-dispute arbitration clauses are enforceable for claims arising under the Exchange Act).

39. 490 U.S. 477, 478 (1989) (holding that pre-dispute arbitration clauses are enforceable for claims arising under the Securities Act, overruling *Wilko v. Swan*, 346 U.S. 427, 430 (1953)). For a full discussion of the evolution of the Supreme Court’s jurisprudence on consumer securities arbitration, see Matthew Eisler, *Difficult, Duplicative and Wasteful?: The NASD’s Prohibition of Class Action Arbitration in the Post-Bazze Era*, 28 CARDOZO L. REV. 1891, 1900–05 (2007). Interestingly, prior to the Supreme Court’s 1953 decision in *Wilko* invalidating pre-dispute arbitration agreements for Securities Act claims, “[f]rom 1925 to 1953, predispute arbitration agreements were regularly enforced in the securities industry.” Moore, *supra* note 5, at 507.

40. See Guy Nelson, *The Unclear “Clear and Unmistakable” Standard: Why Arbitrators, Not Courts, Should Determine Whether a Securities Investor’s Claim Is Arbitrable*, 54 VAND. L. REV. 591, 609 (2001) (“Although they are not mandatory, most brokers demand that their retail customers sign such agreements.”); Barbara Black & Jill I. Gross, *Making It Up As They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 991 (2002) (“[M]ost customer disputes are resolved in arbitration in a dispute resolution

rules of its predecessor, the NASD, have included a requirement that members arbitrate disputes if requested by a customer, regardless of whether the parties executed a separate arbitration agreement.<sup>41</sup>

The current version of that rule is FINRA Rule 12200, which requires that members of FINRA arbitrate a dispute arising in connection with the member’s business activities under certain circumstances.<sup>42</sup> The Rule states in full:

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.<sup>43</sup>

Rule 12200 became effective on April 16, 2007, and incorporated former NASD Rule 10301, which is substantively identical.<sup>44</sup> Notably, Rule 12200 gives the customer the unilateral

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forum sponsored by a securities self-regulatory organization (“SRO”).” (footnote omitted)).

41. The NASD initially codified this rule in section 12 of the NASD Code, which was subsequently recodified into NASD Rule 10301. For a full discussion of the history of section 12, see Moore, *supra* note 5, at 508–09.

42. See *UBS Fin. Servs., Inc. v. Carilion Clinic*, 706 F.3d 319, 324 (4th Cir. 2013) (“In becoming members of FINRA, UBS and Citi agreed to mandatory arbitration of specified disputes with customers when the customer ‘requests’ such arbitration.”); *UBS Sec. LLC v. Allina Health Sys.*, CIV. 12-2090 (MJD/JJG), 2013 WL 500373, at \*4 (D. Minn. Feb. 11, 2013) (“FINRA requires its member firms to resolve disputes with their customers in FINRA arbitration if the conditions in Rule 12200 are satisfied.”).

43. FINRA R. 12200 (2013), available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=4106](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4106).

44. NASD Rule 10301(a) provided:

Any dispute, claim, or controversy eligible for submission under the Rule 10100 Series between a customer and a member and/or associated person arising in connection with the business of such member or in connection with the activities of such associated persons shall be arbitrated under this Code, as provided by any duly executed and enforceable written agreement or upon the demand of the customer.

NASD R. 10301, available at [http://finra.complinet.com/en/display/display\\_viewall.html?rbid=2403&element\\_id=7895&record\\_id=10957](http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=7895&record_id=10957). See also *Herbert J. Sims & Co. v. Roven*, 548 F. Supp. 2d 759, 763 n.2 (N.D. Cal. 2008) (“Rule

right to demand arbitration, giving a customer who did not sign a pre-dispute arbitration agreement the ability to weigh the benefits of proceeding with a claim either through litigation in state or federal court or through the FINRA arbitral forum.<sup>45</sup>

Section 12 of the NASD code [FINRA's predecessor] requires that if desired by a customer, a member must submit a dispute to arbitration. This code section meant that while brokerage firms could not compel arbitration through predispute agreements, customers with claims under federal securities law could compel firms to arbitrate their claims. Since the adoption of the NASD code, in the absence of predispute arbitration agreements, customers can select to arbitrate or litigate.<sup>46</sup>

Unlike customers, FINRA members are required to submit any dispute with another member to arbitration under Industry Code Rule 13200.<sup>47</sup>

In light of the fact that pre-dispute arbitration agreements are nearly universally required by securities firms,<sup>48</sup> it might seem odd

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12200 of the Code is an amended version of former Rule 10301 that went into effect on April 16, 2007. The cases interpreting and applying Rule 10301 apply with equal force to Rule 12200, as the amendment did not effect any substantive change to the rule.”)

45. *Kidder, Peabody & Co. v. Zinsmeyer Trusts P’ship*, 41 F.3d 861, 864 (2d Cir. 1994) (noting that the NASD rules, the predecessor to FINRA, grant “the customer a unilateral option to compel arbitration, a very advantageous power”).

46. Moore, *supra* note 5, at 508–09 (footnotes omitted). *See also* Alexander Ziccardi, *Bucking the Trend: A Case for Rejecting an Emerging Narrow View of Who Qualifies as a Customer in FINRA Arbitration*, 19 PIABA B.J. 57, 58 (2012) (“It is important to note that only the customer can compel arbitration under [FINRA Rule 12200]; the option is unavailable to the member firm.”).

47. The full text of Rule 13200 reads:

Rule 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 R. 13200 (2013), available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=4203](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4203).

that customers might actually prefer arbitration to litigation. Nonetheless, academic research is beginning to recognize that, in certain circumstances, securities arbitration is actually preferable to litigation.<sup>49</sup> Empirical and anecdotal evidence also shows that more and more securities firms are challenging the right of customers to assert their claims in arbitration, suggesting that the securities firms often prefer to face these claims in court.<sup>50</sup>

There are numerous procedural differences between FINRA arbitration and litigation that would inform a customer’s choice of whether to demand arbitration, a few of which include:<sup>51</sup>

- FINRA Rules do not allow dispositive motions (e.g., motions to dismiss, motions for summary judgment) prior to a hearing, except for very limited reasons;<sup>52</sup>

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48. See, e.g., Black, *supra* note 9, at 61 (“Currently, virtually all broker-dealers include in their customers’ agreements a predispute arbitration agreement (PDAA) that requires customers to arbitrate their disputes before the Financial Industry Regulatory Authority (FINRA) arbitration forum.” (footnote omitted)).

49. Eisler, *supra* note 39, at 1893 (“Although arbitration is admittedly not a perfect system, credible empirical data suggests that arbitration provides substantial advantages to claimants as compared to litigation.” (footnote omitted)); Amnon Wenger, Note, *See No Evil, Hear No Evil, Don’t Get Sued: Should A Private Cause of Action Exist for A Violation of NASD Conduct Rule 3010?*, 74 *FORDHAM L. REV.* 303, 314 (2005) (“As courts have restricted the ability of harmed investors to seek redress through litigation, these investors increasingly have turned to arbitration.” (footnote omitted)); Moore, *supra*, note 5, at 518–19 (“It is also crucial to recognize that even if investors and consumers choose to litigate their claims, they are not assured of a more favorable outcome than what they would get in arbitration nor are they guaranteed of any financial savings.” (footnote omitted)); Samuel Estreicher, *Saturns for Rickshaws: The Stakes in the Debate over Predisputes Employment Arbitration Agreements*, 16 *OHIO ST. J. ON DISP. RESOL.* 559, 564 (2001) (arguing that arbitration provides a better option for the many plaintiffs whose claims are not large enough to attract legal representation for litigation).

50. See Black, *supra* note 7, at 419 (“As Howsam illustrates, brokerage firms frequently go to court to enjoin pending arbitrations on grounds that they have not agreed to arbitrate the dispute or that arbitration is inappropriate for some other reason.”); cf. *Smoothline Ltd. v. N. Am. Foreign Trading Corp.*, 249 F.3d 147, 148 (2d Cir. 2001) (noting that parties often go to “herculean efforts to avoid resolution of disputes through arbitration”).

51. For a fuller discussion of the benefits and disadvantages of FINRA arbitration from the customer perspective, see Black & Gross, *supra* note 40, at 1035–40. See also SEC. INDUS. & FIN. MKTS. ASS’N, WHITE PAPER ON ARBITRATION IN THE SECURITIES INDUSTRY (Oct. 2007), available at [http://www.sifma.org/uploadedfiles/societies/sifma\\_compliance\\_and\\_legal\\_society/whitepaperonarbitration-october2007.pdf](http://www.sifma.org/uploadedfiles/societies/sifma_compliance_and_legal_society/whitepaperonarbitration-october2007.pdf) (explaining SRO arbitration procedure to securities industry firms).

- FINRA Rules greatly restrict discovery compared to litigation, as interrogatories and depositions are typically not allowed;<sup>53</sup>
- Arbitration is often considered to be faster and less expensive than litigation;<sup>54</sup>
- FINRA arbitrators are not required to give written reasons for their awards,<sup>55</sup> and their awards are typically not appealable;<sup>56</sup> and

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52. FINRA R. 12504(a) (2013), available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=4141](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4141).

53. FINRA R. 12505–511 (2013), available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=4153](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4153). To view a copy of FINRA’s Discovery Guide (2011), visit FINRA’s website at <http://www.finra.org/ArbitrationAndMediation/Arbitrators/CaseGuidanceResources/DiscoveryGuide/>. See also Mark K. Davis, *Forum Shopping: What Forums Are Available to Investors Who Pursue Claims Against Their Brokers and Which Best Protects Their Rights?*, 14 PIABA B.J. 41, 51 (2007) (“Perhaps the most problematic issues posed by the NASD arbitration process include the rule prohibiting the use of interrogatories, the policy strongly discouraging the use of depositions, and the potential for bias in arbitrators.”). Note that this third issue has been resolved by recent FINRA Rule changes allowing customers to request panels without an industry arbitrator. See *supra* note 6.

54. Moore, *supra* note 5, at 522 (“Unlike litigation, arbitration can also represent a time savings—FINRA arbitration takes an average of twelve months, exhibiting a significant reduction in time invested in the average case.” (footnote omitted)); Estreicher, *supra* note 49, at 564 (“There seems little dispute that because arbitration proceedings tend to be informal (and quicker), they require less lawyer time and resources.” (footnote omitted)). But see Georgios Zekos, *Realities of Securities Arbitration in the USA Today*, 12 VINDOBONA J. OF INTL. COMM. L. & ARBITRATION 33, 41 (2008) (arguing that arbitration is not “quick, economical, or informal” but, in practice, is “much closer to litigation” and citing the statistic that where the average NASD arbitration lasts 17 months, the average time taken to run a case to conclusion in a Federal District Court is 9.3 months”); Black, *supra* note 7, at 452 (reviewing the costs of arbitration and litigation and concluding that an “independent comparison of the costs to investors between arbitration and litigation is necessary before conclusions, even tentative ones, can be made”).

55. FINRA R. 12904 (2013), available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=4192](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4192). The lack of written awards limits the value of an arbitration decision in contexts where collateral estoppel or res judicata might apply, which may disadvantage groups of like-situated claimants. See, e.g., Eisler, *supra* note 39, at 1895–96 (“The arbitral panel rarely delivers its decision with a thorough description of the facts of the case or a textual reasoning for the ruling. Therefore, if an issue is resolved once in arbitration, it would have to be resolved again if that same issue arose in a later proceeding. For example, in actions where numerous claimants are similarly situated, each individual claimant would be forced to resolve their dispute against the same corporate defendant who often has superior resources.

- FINRA arbitrators are not strictly bound to follow the law, and they have recognized claims based on breaches of FINRA regulations that would not constitute valid causes of action in court.<sup>57</sup>

These procedural differences obviously cut both in favor of and against claimants, and weighing whether arbitration or litigation is preferable will depend on the specific facts of the dispute.<sup>58</sup> But on balance, FINRA arbitration is generally regarded as a fair forum for investor–claimants,<sup>59</sup> and in recent years, FINRA has changed its

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This is disadvantageous for claimants, especially if the class action device is not available.” (footnotes omitted)).

56. See, e.g., *Morgan Keegan & Co., Inc. v. Garrett*, 495 F. App’x 443, 446 (5th Cir. 2012) (“Judicial review of an arbitration award is extraordinarily narrow. It is also exceedingly deferential. Importantly, ‘[a]n award may not be set aside for a mere mistake of fact or law.’” (internal citations omitted) (quoting *Apache Bohai Corp. LDC v. Texaco China BV*, 480 F.3d 397, 401 (5th Cir. 2007))); see also Black, *supra* note 7, at 453 (noting that the FAA provides only “limited judicial review of arbitration awards to assure that the process was fair”).

57. See Black & Gross, *supra* note 40, at 1040–43 (arguing that arbitration allows investors to assert claims based on “margin sellouts, economic suicide, and liability of clearing brokers,” which would be dismissed in court); Wenger, *supra* note 49, at 316 (arguing that “failure to supervise” claims are frequently raised in arbitration, in large part because courts refuse to recognize such claims).

58. See Black, *supra* note 9, at 93–105. As the author wrote:

Once a dispute has arisen, each side will have a view about whether its claim will fare better in court or in arbitration. . . . Consider, for example, a \$25,000 claim for a breach of the suitability rule. The investor is likely to want arbitration, while the firm has strategic advantages to insist on court. It will not be cost-efficient for the investor to litigate this claim, and there is no private cause of action for breach of an SRO rule. Conversely, if a disabled investor has a \$5 million claim against his broker-dealer for fraudulent misrepresentations that caused him to lose his money in a Ponzi scheme, the investor’s attorney will likely want to take the case to a jury, with all the attendant publicity, while the firm would prefer arbitration of the claim.

*Id.* at 93.

59. *Id.* at 73 (“Many investors perceive the FINRA arbitration forum as unfair, although academics who have studied the forum award it high marks for meeting most generally recognized standards of fairness.” (footnotes omitted)); Jill I. Gross, *McMahon Turns Twenty: The Regulation of Fairness in Securities Arbitration*, 76 U. CIN. L. REV. 493, 517 (2008) (“My review has led me to conclude that, as a result of SEC oversight, investors have access to a fundamentally fair dispute resolution process that enables them to vindicate their statutory rights to the same degree as, if not more so, than in court.”).



rules to resolve some of the investors' principal complaints.<sup>60</sup> In short, the right to choose between litigation and FINRA arbitration is indeed a "very advantageous power,"<sup>61</sup> as long as the claimant is a "customer" who has the power to choose.

### III. CASE LAW ON "CUSTOMER" UNDER FINRA RULE 12200 AND ITS ANTECEDENTS<sup>62</sup>

Although FINRA Rule 12200 plainly creates a right for customers of FINRA members to demand arbitration of claims arising out of a member's business activities,<sup>63</sup> FINRA provides very little guidance as to what categories of persons are "customers" entitled to demand

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60. One of the principal previous complaints that investors had about FINRA arbitration was that panels were required to have one industry arbitrator, which many investors perceived to be a conflict of interest. *See, e.g.*, Moore, *supra* note 5, at 511 ("It is significant that FINRA is the only arbitration provider for consumer-broker disputes given the nature of FINRA arbitration and what some consumers feel is a biased system that favors the interests of industry defendants over the interests of consumers. At the core of the allegations of bias is the fact that in three-member arbitration panels, one member is part of the securities industry because they are a FINRA member." (footnotes omitted)). In 2011, FINRA changed this rule, allowing customers to choose an "all-public panel," which would have no arbitrators presently employed in or representing the securities industry. FINRA R. 12403 (2013), available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=4141](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4141) (amending 2011 version of rule to simplify panel selection process while reaffirming customer's right to an all-public panel).

61. *Kidder, Peabody & Co. v. Zinsmeyer Trusts P'ship*, 41 F.3d 861, 864 (2d Cir. 1994).

62. FINRA Rule 12200 is the successor rule to NASD Section 12 and NASD Rule 10301, all of which are substantively identical on the issue of the ability of customers to demand arbitration. *See supra* notes 42–47 and accompanying text. Courts routinely rely on case law interpreting the prior rules in resolving cases arising under Rule 12200. *See supra* note 44. In order to provide clarity in the text, this Article will refer to FINRA Rule 12200 throughout, even though much of the case law predates the current iteration of the rule.

63. *See, e.g.*, *Oppenheimer & Co. v. Neidhardt*, No. 93 Civ. 3854 (SS), 1994 WL 176976, at \*1 (S.D.N.Y. May 5, 1994), *aff'd*, 56 F.3d 352 (2d Cir. 1995) ("Member securities dealers are subject to a compulsory arbitration agreement intended directly to benefit their customers." (footnote omitted)); *Scobee Combs Funeral Home, Inc. v. E.F. Hutton & Co.*, 711 F. Supp. 605, 607 (S.D. Fla. 1989) ("Parties may create rights in a third-party beneficiary by manifesting an intention to do so. . . . In this case, the very words of the NASD provision on required submission to arbitration indicate that member securities dealers intended to directly benefit their customers by granting them a right to demand arbitration, even in the absence of a written agreement." (internal citations omitted)).

arbitration.<sup>64</sup> The only definition that FINRA provides of the term “customer” is that it “shall not include a broker or dealer.”<sup>65</sup> This negative definition is not only remarkably uninformative,<sup>66</sup> but when combined with other FINRA rules that require arbitration of disputes between brokers and dealers,<sup>67</sup> the definition appears to suggest that FINRA members are required to submit to arbitration demanded by literally anyone. Courts have not hesitated to find this definition alone “too broad.”<sup>68</sup>

Unsatisfied with the negative definition, courts have sought to move beyond it and positively determine whether a party seeking arbitration is a customer of a member. This Section will examine the case law across a number of contexts including: (1) privity between the member and the customer; (2) issuers of securities, rather than

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64. See Ziccardi, *supra* note 46, at 59 (“[S]ome members of the industry have suggested to FINRA that it should offer a more comprehensive definition of customer. The Approval Order for the amendments made to the Customer Code effective after April 16, 2007 noted that many commenters requested a more comprehensive definition of customer. Despite these requests, FINRA opted to retain the bare-bone definition of customer when it adopted its new Customer Code.” (footnote omitted)).

65. FINRA R. 12100(i) (2013), available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=4099](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4099).

66. See, e.g., *Morgan Keegan & Co. v. Agresti*, No. 11-5229 (PGS), 2012 WL 4505897, at \*3 (D.N.J. Sept. 28, 2012) (“Rather than provide an affirmative definition of ‘customer,’ Rule 12100(i) of the FINRA Code defines ‘customer’ only in the negative, as it states: ‘[a] customer shall not include a broker or dealer.’” (alteration in original)).

67. See FINRA R. 13200(a) (2013), available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=4203](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4203) (“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.”); FINRA R. 13100(o) (2013), available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=4196](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4196). (“For purposes of the Code, the term ‘member’ means any broker or dealer admitted to membership in FINRA, whether or not the membership has been terminated or cancelled; and any broker or dealer admitted to membership in a self-regulatory organization that, with FINRA consent, has required its members to arbitrate pursuant to the Code and/or to be treated as members of FINRA for purposes of the Code, whether or not the membership has been terminated or cancelled.”).

68. *Fleet Boston Robertson Stephens, Inc. v. Innovex, Inc.*, 264 F.3d 770, 772 (8th Cir. 2001) (“[The defendant] argues that by negative inference this definition means a ‘customer’ is everyone who is not a broker or dealer. We agree with the district court that this definition is too broad.”). *But see* *Bank of the Commonwealth v. Hudspeth*, 714 S.E.2d 566, 572 (Va. 2011) (holding that a bank was a “customer” entitled to compel arbitration of a claim brought against the bank by its former vice president who was also a registered securities representative based primarily on the definition of customer as not “a broker or dealer” and the presumption in favor of arbitration).

investors; (3) members who provide banking or financial advice to a customer; and (4) timing issues presented by former customers and/or former members. The goal of this survey is to show where courts have decided to draw the line on who is a customer in each of these contexts.

*A. Privity Between the Customer and a Member*

There is no dispute over the fact that investors are customers of their brokers under FINRA Rule 12200. This investor–broker relationship is the prototypical customer relationship that FINRA members point to when arguing that other relationships do not qualify the claimant as a customer.<sup>69</sup> But even when investors seek arbitration under Rule 12200, there is an issue of whether the relationship between the investor and the FINRA member is substantial enough to justify calling the investor that member’s customer. Essentially, this is a privity issue: How closely connected to the FINRA member does the investor have to be to qualify as a customer who can demand arbitration?

One of the first cases to consider privity was *Oppenheimer & Co. v. Neidhardt*, in which the Second Circuit considered a situation where investors intended to invest through a FINRA member, but due to fraud of that member’s associated person,<sup>70</sup> the FINRA member

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69. See, e.g., *UBS Fin. Servs., Inc. v. W. Va. Univ. Hosps., Inc.*, 660 F.3d 643, 652 (2d Cir. 2011) (“We also reject UBS’s contention that FINRA has a narrow ‘investor-protection mandate,’ such that ‘customers’ should include only those receiving ‘investment or brokerage services.’”); *Fleet Boston*, 264 F.3d at 771 (“This question hinges upon whether the term ‘customer’ applies only to those who received investment or brokerage services, or whether it also applies to those who received banking and financial advice, as AdFlex did in this case.”).

70. Associated person is defined by the FINRA rules as:  
(1) a natural person registered under NASD Rules; or (2) a sole proprietor, or any partner, officer, director, branch manager of the Applicant, or any person occupying a similar status or performing similar functions; (3) any company, government or political subdivision or agency or instrumentality of a government controlled by or controlling the Applicant; (4) any employee of the Applicant, except any person whose functions are solely clerical or ministerial; (5) any person directly or indirectly controlling the Applicant whether or not such person is registered or exempt from registration under the FINRA By-Laws or NASD Rules; (6) any person engaged in investment banking or securities business controlled directly or indirectly by the Applicant whether such person is registered or exempt from registration under the FINRA By-Laws or NASD Rules; or (7) any person who will be or is anticipated to be a person described in (1) through (6) above.  
FINRA R. 1011(b) (2013), available at [http://finra.complinet.com/en/display/display.html?rbid=2403&element\\_id=3567&print=1](http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=3567&print=1).

was never aware of the investors.<sup>71</sup> The *Neidhardt* claimants were investors who were defrauded when a vice president of Oppenheimer solicited their funds to open an account at Oppenheimer but instead opened the account in the name of an unrelated corporation, listing two of the vice president’s fraudulent confederates as the corporation’s controlling officers.<sup>72</sup> When the investors sought to compel arbitration, Oppenheimer objected, claiming that the account was set up in the name of the corporation and that the investors were “strangers to Oppenheimer[, which] never agreed to establish a customer relationship with them.”<sup>73</sup> The court rejected this analysis, relying on the fact that Oppenheimer was responsible for the acts of its vice president, whose diversion of the funds into an account under the name of a third party was “the very fraud of which [the investors] complain[ed]. Having turned over their funds to Oppenheimer’s representative so as to become customers of Oppenheimer, the Claimants did not lose the legal benefits of customer status because Oppenheimer’s representative fraudulently established their account in a manner designed to conceal and defeat their interest.”<sup>74</sup>

The Second Circuit revisited the privity issue in *John Hancock Life Insurance Co. v. Wilson*, at one level removed, where investors intended to invest with a representative of a FINRA member but were not aware of the representative’s relationship with the FINRA member.<sup>75</sup> In *John Hancock*, the investors purchased fraudulent promissory notes from a broker.<sup>76</sup> Although the broker was a registered representative of John Hancock, a FINRA member, the investors were unaware of the relationship between the broker and John Hancock and did not intend to invest through John Hancock.<sup>77</sup> Further, John Hancock had not authorized the broker to sell the promissory notes at issue, nor did John Hancock have knowledge that the broker was selling the products.<sup>78</sup> As the Second Circuit summarized, “The only possible connection between John Hancock and the Investors was through their independent relationships with [the representative].”<sup>79</sup>

In finding that the investors were nonetheless customers of John Hancock, the Second Circuit began by examining the Rule as a whole and noted that in several places it refers both to the “member and/or

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71. 56 F.3d 352 (2d Cir. 1995).

72. *Id.* at 354.

73. *Id.* at 357.

74. *Id.*

75. 254 F.3d 48, 51 (2d Cir. 2001).

76. *Id.*

77. *Id.*

78. *Id.*

79. *Id.*

the associated person.”<sup>80</sup> The Second Circuit then emphasized both that FINRA’s negative definition of “customer” is very broad and that courts interpreting the Rule have supported “a broad interpretation of the term ‘customer.’”<sup>81</sup> Relying solely on the plain language of the Rule, the court concluded that the investor was entitled to demand arbitration from John Hancock.<sup>82</sup>

The Second Circuit revisited the privity issue a third time in *Bensadoun v. Jobe-Riat*, at yet another level of removal.<sup>83</sup> In *Bensadoun*, the Second Circuit considered the issue of whether investors, whose broker was a customer of a member’s associated person, can also claim to be customers of the member.<sup>84</sup> As alleged by the respondents,<sup>85</sup> the investors had given their money to a third party, Autard, to invest the money through his own Swiss company.<sup>86</sup> Autard then opened an account with Bensadoun, and only Autard and the Swiss company had control of the account.<sup>87</sup> The Swiss company went bankrupt and Autard was arrested for embezzlement, so neither was named in the complaint.<sup>88</sup> The issue before the Second Circuit was whether the fact that Autard invested the investors’ funds with Bensadoun made the investors customers of Bensadoun.<sup>89</sup>

The Second Circuit focused on a need for a “direct customer relationship between the associated person and the purported customer.”<sup>90</sup> In particular, the Second Circuit focused on whether the

80. *Id.* at 58 (“First, the Investors’ claims must constitute a ‘dispute . . . between a customer and a member and/or associated person.’ Second, the dispute must ‘aris[e] in connection with the business of such member or in connection with the activities of such associated persons.’” (quoting NASD R. 10301)). This is not a particularly compelling argument because FINRA arbitrates disputes between customers and both members and associated persons, so the Rule’s disjunctive use of “member and/or the associated person” could be seen as clarifying that the rule applies. See FINRA R. 12101 (2013), available at [http://finra.complinet.com/en/display/display.html?rbid=2403&record\\_id=5179&element\\_id=4100&highlight=applicability&print=1](http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=5179&element_id=4100&highlight=applicability&print=1).

81. *John Hancock*, 254 F.3d at 60.

82. *Id.* (“As our decision today is grounded in the plain language of the relevant provisions of the NASD Code, we do not delve into any extrinsic evidence regarding the NASD’s intent.” (citation omitted)).

83. 316 F.3d 171, 176 (2d Cir. 2003) (“Here, [as compared to *John Hancock*], the entire framework is removed by one level.”).

84. *Id.* at 175–76.

85. The Second Circuit in *Bensadoun* was considering a district court’s dismissal of an action to stay arbitration, and so the question before the court was whether there was a “[t]riable [i]ssue as to [w]hether the [i]nvestors [q]ualify as ‘[c]ustomers’ of Bensadoun[.]” *Id.* at 175.

86. *Id.* at 173.

87. *Id.*

88. *Id.*

89. *Id.* at 175–76.

90. *Id.* at 176.

customers had relinquished investment authority to Autard and considered the parade of horrors if “every purchaser of shares in a mutual fund and every beneficiary of a pension fund would arguably be ‘customers’ of every investment institution with which those funds do business, and would be entitled to demand arbitration under the NASD.”<sup>91</sup> The Second Circuit thus established the rule that “where investors pool their funds and relinquish all investment authority to a third party who deals with an NASD broker, that third-party, not the investors, will normally be the broker’s customer.”<sup>92</sup>

*Neidhardt* and *John Hancock* have come to stand for the proposition that an investor’s relationship with an associated person of a FINRA member will create a customer relationship with the broker–dealer even if there is no direct relationship between the investor and the broker–dealer.<sup>93</sup> And *Bensadoun* establishes the limit to that proposition: Where investors invest through a third-party broker and the broker invests with the associated person of a FINRA member, the investors will not be customers of the associated person.<sup>94</sup>

Courts have applied these principles in a number of contexts. The Eighth Circuit in *Berthel Fisher & Co. Financial Services v. Larmon* held that investors who purchase securities from a selling group member in an initial offering are not customers of the managing broker–dealer who manages the underwriting.<sup>95</sup> As managing broker–dealer of the underwriting,

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91. *Id.* at 177.

92. *Id.* at 178.

93. *See, e.g., Vestax Sec. Corp. v. McWood*, 280 F.3d 1078, 1082 (6th Cir. 2002) (citing *John Hancock* and *Oppenheimer* for the proposition that “[a] number of courts have held that an agent or representative of a financial services firm is an ‘associated person’ under NASD Rule 10301(a) such that a relationship with the agent entitles the investor to the arbitration process[,]” while reaching the same result); *MONY Sec. Corp. v. Bornstein*, 390 F.3d 1340, 1344 (11th Cir. 2004) (“We thus hold that the Bornsteins are customers under the applicable NASD Rules because it is undisputed that they are customers of Keller, and that Keller was an associated person with MONY.”); *Contemporary Fin. Solutions, Inc. v. Miller*, No. 07-cv-00793-MSK, 2007 WL 4197588, at \*4 (D. Colo. Nov. 20, 2007) (“In addition, to be a customer of an ‘associated person,’ the investor need not have any knowledge of the associated person’s affiliation with the NASD member, nor need the associated person have been given authority by the NASD member to conduct the particular transaction.”).

94. *See Black, supra* note 7, at 422–23 (noting that courts have consistently held that investors are not “customers” of a firm when they “[do] business with a person who was not associated with the firm, who in turn transacted business with the firm” (footnote omitted)).

95. 695 F.3d 749, 753 (8th Cir. 2012).

Berthel assembled a group of FINRA-registered broker-dealers—Selling Group Members, or SGMs—who in turn offered the securities to their own customers, including the Investors. . . . Berthel reviewed at least two of the PPMs, suggesting changes that [the issuer] adopted. Per the agreement between Berthel and the SGMs, Berthel collected investor payments from the SGMs and passed those payments along to Geneva.<sup>96</sup>

The Eighth Circuit concluded that the investors were not customers of the managing broker-dealer because Berthel provided its services to the selling group members, not to the investors.<sup>97</sup> The court noted that “the provision of ‘investment or brokerage related services’ is only half of the picture—not only must the FINRA member firm provide those services, but also must it provide those services *to the customer* either directly or through its associated persons.”<sup>98</sup>

In *Morgan Keegan & Co. v. Silverman*, the Fourth Circuit held that investors who purchased securities after an initial public offering from third parties in the secondary market were not customers of the underwriter of the initial public offering.<sup>99</sup> Investors complained that Morgan Keegan had distributed misleading marketing material and directly encouraged their broker to purchase the securities.<sup>100</sup> The Fourth Circuit noted that the investors did not purchase any services or commodities from Morgan Keegan but rather purchased shares from a third party.<sup>101</sup> The court found that contact between Morgan Keegan and the investor’s broker was insufficient to make the investors “customers” of Morgan Keegan.<sup>102</sup>

In *Raymond James Financial Services, Inc. v. Cary*,<sup>103</sup> the Fourth Circuit held that investors who purchase securities from a third party who was purportedly acting as an agent or coconspirator of a registered representative were not customers of the registered representative or his member firm.<sup>104</sup> The investors in *Raymond James* admitted that they bought their securities directly through the issuer and that they had no personal contact with the registered representative, were not told that the third party who sold them the

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96. *Id.* at 751.

97. *Id.* at 753.

98. *Id.*

99. 706 F.3d 562 (4th Cir. 2013).

100. *Id.* at 564.

101. *Id.* at 567–68.

102. *Id.*

103. 709 F.3d 382, 388 (4th Cir. 2013).

104. *Id.*

securities was affiliated with Raymond James, and did not understand that they were purchasing the security from Raymond James or an agent authorized to act on its behalf.<sup>105</sup> But the investors contended that the registered representative was receiving commissions from their transactions based on an agreement with the third-party broker to split all commissions, thereby establishing the requisite relationship.<sup>106</sup> The Fourth Circuit noted that “mere interaction between a member firm and a third party [will not] transform an investor who dealt only with the third party into a customer of the member firm.”<sup>107</sup> Because the investors did not purchase any commodities or services from the FINRA member, they were not customers.<sup>108</sup>

### *B. Issuers of Securities*

A number of courts have considered whether an entity that issues securities—either stocks or bonds—that are underwritten or remarketed by a FINRA member is a customer that can demand arbitration.<sup>109</sup> Issuers, whether corporate, governmental, or nonprofit, occupy the opposite end of the securities spectrum from investors. They turn to FINRA members not to purchase products but rather to raise funds through the sale of securities for a variety of projects.

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105. *Id.* at 384–85.

106. *Id.* at 386–87.

107. *Id.* at 387. Interestingly, the court emphasized that the third-party broker had neither actual nor apparent authority from Raymond James, suggesting that apparent authority might create a customer relationship in the appropriate case. *Id.* at 387–88.

108. *Id.* at 388.

109. See Alison Frankel, *Banks, Bond Issuers and FINRA: A Match Made in Federal Court*, THOMSON REUTERS NEWS & INSIGHT, Oct. 2, 2012. As the article stated:

UBS argued that ARS issuers don’t fall within FINRA’s definition of a brokerage customer. Despite the bank’s protests, judges in Virginia and California sided with the issuers and declined to enjoin their FINRA arbitrations. This week’s decisions are the latest in a string of federal court rulings that have generally supported debt issuers’ insistence that they are brokerage clients. Financial services firms such as UBS, JPMorgan, Citigroup and Goldman Sachs have argued that FINRA arbitration is only available to traditional clients. But at least five U.S. district judges have ruled that issuers of municipal or corporate debt can be considered customers, thus permitting their FINRA arbitrations to move forward.

*Id.*



Unlike the privity cases, these issuer cases consider the range of relationships that can justify customer status.<sup>110</sup>

The Third Circuit was the first court to consider whether an issuer was a customer of a FINRA member in *Patten Securities Corp. v. Diamond Greyhound & Genetics, Inc.*<sup>111</sup> In *Patten*, a Colorado corporation contracted with Patten to serve as underwriter for the sale of the corporation's shares and warrants.<sup>112</sup> When the parties never consummated the deal, the corporation demanded arbitration, and Patten sought to enjoin the arbitration, contending that the corporation was not Patten's customer.<sup>113</sup> The court did not extensively analyze the legal issue, instead relying on an interpretive statement from the NASD's National Arbitration Committee that stated, "An issuer of securities should be considered a public customer of a member firm where a dispute arises over a proposed underwriting."<sup>114</sup> The court concluded that because the interpretive statements of the Committee were final, conclusive, and binding on NASD members, the corporation was a customer entitled to demand arbitration.<sup>115</sup>

The issue next arose in *J.P. Morgan Securities Inc. v. Louisiana Citizens Property Insurance Corp.*<sup>116</sup> In that case, the Southern District of New York considered whether an issuer of auction rate securities (ARS) was a customer of a FINRA member that served both as underwriter and remarketer of the bonds.<sup>117</sup> The issuer in *Louisiana Citizens* alleged that J.P. Morgan and Bear Stearns advised<sup>118</sup> Citizens to issue auction rate bonds and received fees and compensation for acting as the co-lead underwriters and providing bridge financing in connection therewith.<sup>119</sup> According to Citizens, J.P. Morgan and Bear Stearns were manipulating the market for

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110. See *Ross Sinclair & Assocs. v. Premier Senior Living, LLC*, No. 11-CV-5104 YGR, 2012 WL 2501115, at \*7 (N.D. Cal. June 27, 2012) ("However, no case in this district has addressed the situation here, that is, a situation where the connection between the purported customer and the FINRA member is undisputedly direct, but the 'customer' is a purchaser of services related to the issuance and sale of securities rather than an investor in securities.").

111. 819 F.2d 400, 405–07 (3d Cir. 1987), *abrogated on other grounds*.

112. *Id.* at 402.

113. *Id.* at 402–03.

114. *Id.* at 406.

115. *Id.*

116. 712 F. Supp. 2d 70 (S.D.N.Y. 2010).

117. "Auction rate securities" are long-term bonds with interest rates that reset in periodic auctions. Issuers of ARS engaged FINRA members—often the same firm that performed the underwriting—to conduct the auctions, and only authorized broker-dealers were entitled to submit bids in the periodic auctions. *Id.* at 77–79.

118. Citizens alleged that J.P. Morgan and Bear Stearns acted as advisers for the bond structure, but the underwriters disputed this fact. *Id.* at 73.

119. *Id.* at 72–73.

auction rate bonds to maintain the appearance that the bonds would generate interest rates favorable to Citizens, and when they discontinued these manipulations, the market collapsed causing economic loss to Citizens.<sup>120</sup> J.P. Morgan and Bear Stearns sought to enjoin a FINRA arbitration filed by Citizens, contending that customers should be limited to investors.<sup>121</sup>

The court in *Louisiana Citizens* rejected that argument.<sup>122</sup> It noted first that *Fleet Boston Robertson Stephens, Inc. v. Innovex, Inc.*, the principal case relied upon by J.P. Morgan and Bear Stearns, cited *Patten* with approval, saying that “although the relationship [in *Patten*] was not a broker/investor relationship, [the issuer/underwriter relationship] still related directly to the issuance of securities, rather than banking advice.”<sup>123</sup> It then noted that while many cases conclude that an investor is a customer of the financial firm that acts as its broker, “they do not support the conclusion that the broker–investor relationship is the only relationship sufficient to satisfy Rule 12200. The rule that an investor is a customer of its broker is a rule of inclusion, not exclusion.”<sup>124</sup> In light of the Second Circuit’s precedents instructing courts to interpret ambiguity in favor of arbitration,<sup>125</sup> the nonrestrictive definition of “customer” provided by FINRA, and the lack of precedent further restricting the term, the court in *Louisiana Citizens* concluded that issuers were customers of underwriters and could demand arbitration of their disputes.<sup>126</sup>

In *UBS Financial Services, Inc. v. West Virginia University Hospitals, Inc.*, the Second Circuit addressed whether issuers are customers in a case presenting largely identical facts to *Louisiana Citizens*.<sup>127</sup> West Virginia University Hospitals (WVUH) also issued ARS with UBS serving as its underwriter and broker–dealer.<sup>128</sup> WVUH contended that it was a customer because it paid UBS for these broker–dealer services, although UBS countered that the parties’ contracts provided that UBS would facilitate the auctions “for the benefit of the beneficial owners of the [ARS].”<sup>129</sup>

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120. *Id.* at 74.

121. *Id.* at 78.

122. *Id.*

123. *Id.* (alteration in original) (quoting *Fleet Boston Robertson Stephens, Inc. v. Innovex, Inc.*, 264 F.3d 770, 773 n.3 (8th Cir. 2001)).

124. *Id.*

125. *Id.* at 78–79.

126. *Id.* This conclusion, of course, also hinged on the court finding that the other elements of FINRA Rule 12200 were met.

127. See 660 F.3d 643, 650–52 (2d Cir. 2011).

128. *Id.* at 645.

129. *Id.* at 646. The court later rejected the argument that just because the contract between UBS and WVUH referred to the payment as being for the benefit of the public, that the public—and not WVUH—was a customer of UBS

In finding that WVUH was a customer of UBS entitled to demand arbitration, the Second Circuit relied heavily on the fact that WVUH bought specific services from UBS, namely broker–dealer services.<sup>130</sup> Relying on the dictionary definition of “customer” as “someone who buys goods or services,”<sup>131</sup> the court adopted a definition of “customer” that included “at least a non-broker or a non-dealer who purchases, or undertakes to purchase, a good or service from a FINRA member.”<sup>132</sup> The court reached this definition based on the broad scope of the FINRA rules, broad definitions found in other FINRA publications,<sup>133</sup> and the lack of prior precedents purporting to give an “exhaustive” definition of “customer.”<sup>134</sup> Given the broad scope of the term, the court concluded that where WVUH paid for UBS to perform broker–dealer services, WVUH was a “customer” under FINRA 12200.<sup>135</sup> Significantly, though, the court limited its finding to the broker–dealer relationship and did not decide whether the underwriter–issuer relationship was sufficient to make WVUH a customer of UBS.<sup>136</sup>

UBS also argued that FINRA arbitration was not intended for sophisticated parties like WVUH that are not investors and that allowing issuers to arbitrate does not serve FINRA’s “investor-protection mandate.”<sup>137</sup> The court rejected these arguments, noting that FINRA’s rules contemplate arbitration in “large or complex cases” and that FINRA’s purposes are clearly broader than investor

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under the broker–dealer agreement. “We reject UBS’s suggestion that WVUH, a sophisticated party seeking to raise capital, charitably undertook to pay a substantial fee for the benefit of unknown investors rather than itself.” *Id.* at 651.

130. *Id.* at 648.

131. *Id.* at 650.

132. *Id.*

133. *Id.* at 650 (quoting *Glossary of Arbitration Terms*, FINRA, <http://www.finra.org/ArbitrationMediation/Glossary/> (last visited Sept. 19, 2011) (defining “customer” as “[a] person or entity (not acting in the capacity of an associated person or member) that transacts business with any member firm and/or associated person”). Remarkably, after the publication of the decision, FINRA altered this page of its website to replace the definition of “customer” with a definition of “investor” that is substantively identical. See *Glossary of Arbitration Terms*, FINRA, <http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Glossary/> (last visited Oct. 24, 2013) (defining “investor” as “[a] person or entity (not acting in the capacity of an associated person or member) that transacts business with any member firm and/or associated person”).

134. *W. Va. Univ. Hosps.*, 660 F.3d at 650.

135. *Id.* at 651–52.

136. *Id.*

137. *Id.* at 652.

protection.<sup>138</sup> Finally, the court gave little credence to UBS’s contention that a customer relationship would require “a fiduciary relationship and cannot be founded on arm’s length transactions,” finding no support for this proposition in “the text or the structure of the FINRA Rules.”<sup>139</sup>

Interestingly, the Second Circuit’s decision engendered a lengthy dissent. The dissent focused on whether WVUH could be a customer of its underwriter and attacked the application of the majority’s definition:

The majority focuses on the plain-meaning definition of “customer”: one who “purchases, or undertakes to purchase a good or service from a FINRA member.” . . . There is no record evidence in this case that WVUH undertook to pay or paid, in any form, UBS for underwriting the issuance of WVUH ARS or providing advice in connection with the issuance. As in any other negotiated underwriting transaction, UBS purchased the WVUH ARS from WVUH at a discount and resold the ARS in the market to UBS’s customers. In that transaction, UBS took on the risks inherent in an offering of securities, and there is no record evidence that WVUH carried a cost for this transaction on its books. Thus, as explained below, WVUH did not “purchase” any goods or services from UBS pursuant to the underwriting agreement and thus did not become UBS’s customer pursuant to that agreement.<sup>140</sup>

The dissent’s principal complaint with the majority’s reasoning was that the majority “shoehorned” a dispute about underwriting into arbitration based on payments for an unrelated transaction.<sup>141</sup> But fundamentally, the dissent agreed with the majority’s definition of “customer” that included an issuer who purchases services from an underwriter; the dissent’s dispute was simply whether that standard was met by WVUH.<sup>142</sup>

Completing a triptych of ARS cases, the Fourth Circuit in *UBS Financial Services, Inc. v. Carilion Clinic* addressed whether an issuer of auction rate securities was a customer for purposes of FINRA 12200.<sup>143</sup> The facts of *Carilion* were similar to *Louisiana*

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138. *Id.* at 651.

139. *Id.* at 652.

140. *Id.* at 659 (Preska, J., dissenting) (citations omitted).

141. *Id.* at 660, 662 (“It is not reasonable, as the majority opinion presumes, to think that the parties to the FINRA Rules agreed that once ‘customer’ status is established through a single transaction or agreement, any related matter may be arbitrated.”).

142. *Id.* at 656.

143. 706 F.3d 319, 323–28 (4th Cir. 2013).

*Citizens and West Virginia University Hospitals*, although Carilion alleged that in addition to payments for serving as broker–dealer for Carilion’s auctions, in connection with the underwriting of Carilion’s bonds “UBS and Citi earned an underwriter’s discount, part of which constituted a management fee for their assistance in structuring and managing the transaction.”<sup>144</sup> The Fourth Circuit followed the Second Circuit’s ruling in *West Virginia University Hospitals* but adopted a more comprehensive definition of “customer”:

[W]e conclude that “customer,” as that term is used in the FINRA Rules, 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.<sup>145</sup>

Based on that definition and the management fee alleged by Carilion, the court had “little difficulty concluding that Carilion is such a ‘customer.’”<sup>146</sup>

### C. Banking and Financial Advice

The Eighth Circuit, in *Fleet Boston*, considered whether someone who received banking or financial advice, as opposed to investment

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144. *Id.* at 322.

145. *Id.* at 327.

146. *Id.* See also *Ross Sinclair & Assocs. v. Premier Senior Living, LLC*, No. 11-CV-5104 YGR, 2012 WL 2501115, at \*10 (N.D. Cal. June 27, 2012) (finding that an issuer is a customer where “the undisputed evidence shows that the PSL Defendants purchased from RPS investment advice and financial services in connection with the creation and sale of securities”); *UBS Sec. LLC v. Allina Health Sys.*, Civil No. 12-2090 (MJD/JJG), 2013 WL 500373, at \*5 (D. Minn. Feb. 11, 2013) (“In light of the business relationship between Allina and UBS [issuer and underwriter/broker–dealer], and the services paid for and received by Allina, the Court finds that Allina is a customer of UBS as the term is defined in FINRA Rule 12100(i).”); *UBS Fin. Servs. Inc. v. City of Pasadena*, No. CV 12-05019-RGK(JCx), 2012 WL 3132949, at \*4 (C.D. Cal. July 31, 2012) (“Here, Defendant hired Plaintiffs to perform the underwriting services on both of its ARS offerings. Given the business relationship existing between the two parties and the services received by Defendant, the Court finds that Defendant is likely a customer of Plaintiffs as that term is defined in Rule 12100(i).”); *Goldman, Sachs & Co. v. City of Reno*, No. 3:12-cv-00327-RCJ-WGC, 2012 WL 5944966, at \*4 (D. Nev. Nov. 26, 2012) (“Here, as in [*West Virginia University Hospitals*], the FINRA member has provided more than financial advice, but rather has provided services directly related to the securities, i.e., facilitation of auctions of the securities themselves. The Court finds this to be sufficiently related to the broker-dealer function for the City [to] fall under the definition of ‘customer.’”).

or brokerage services, could qualify as a customer under the FINRA rules.<sup>147</sup> The defendants sought to compel arbitration of claims relating to unpaid fees and expenses for financial and banking advice provided by Fleet Boston in connection with the defendants’ merger.<sup>148</sup> The court rejected the defendants’ argument that “the NASD 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.”<sup>149</sup>

In particular, the Eighth Circuit surveyed the NASD Rules that addressed conduct of members toward investors,<sup>150</sup> as well as a NASD Notice to Members describing the purpose of the arbitration forum as assisting “in the resolution of monetary and business disputes between investors and their securities firms,” and concluded that “customer” “refers to one involved in a business relationship with an NASD member that is related directly to investment or brokerage services.”<sup>151</sup> The court further noted that even in cases that had suggested a broader view of “customer,” such as *Neidhardt* or *Patten* discussed above, “there existed some brokerage or investment relationship between the parties” or the relationship “related directly to the issuance of securities, rather than banking advice.”<sup>152</sup>

The scope of noninvestment-related activities that could give rise to customer status was further explored by two Second Circuit cases involving derivative products purchased by VCG, a hedge fund: *Citigroup Global Markets, Inc. v. VCG Special Opportunities Master*

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147. 264 F.3d 770, 771 (8th Cir. 2001) (“[T]he only question is whether [the plaintiff] is a ‘customer’ of Robertson Stephens under the NASD Code. This question hinges upon whether the term ‘customer’ applies only to those who received investment or brokerage services, or whether it also applies to those who received banking and financial advice, as [the plaintiff] did in this case.”).

148. *Id.*

149. *Id.* at 772.

150. *Id.* (citing NASD Rules of Conduct § 2270; “§ 2230 (governing broker transaction confirmations); § 2260 (forwarding securities related information); § 2280 (investor education); § 2310 (investment recommendations); § 2320 (executing orders); § 2330 (maintaining customer’s securities and accounts); §§ 2400-2460 (commissions on brokerage accounts and securities transactions); §§ 2700-2780 (securities distributions)”). In a footnote, the court refuted the significance of “an isolated NASD Rule relating to membership and registration that defines a ‘customer’ to include those receiving investment banking services . . . which d[id] not specifically deal with customer protection or relations, [as] insufficient to expand the definition of ‘customer’ for purposes of the arbitration provision.” *Id.* at 772 n.2 (citing NASD Membership and Registration Rule § 1120(b)(1)).

151. *Id.* at 772.

152. *Id.* at 772, 773 n.3.

*Fund Ltd.*<sup>153</sup> and *Wachovia Bank, National Ass'n v. VCG Special Opportunities Master Fund, Ltd.*<sup>154</sup> In *Citigroup*, VCG alleged that it was Citigroup's customer because it had a long-term brokerage relationship with Citigroup and Citigroup's employees had "recommended and set the terms for" the credit default swap at issue between VCG and Citibank, a non-FINRA member.<sup>155</sup> Citigroup responded that its employees, all FINRA-registered individuals, were serving as representatives of Citibank at the time and that the transaction was an arm's-length transaction, where VCG explicitly disavowed any reliance on Citigroup's employees.<sup>156</sup> The district court granted a preliminary injunction of VCG's arbitration, finding that there were serious questions that required further factual explication.<sup>157</sup> The district court found that "financial advice and involvement with the terms of the CDS contract" could "create a customer relationship between [Citigroup] and VCG," although there were factual disputes about the precise role played by Citigroup's employees.<sup>158</sup> The court further noted that although a credit default swap is not a security, "there is authority for the proposition that the term 'arises in connection with the business activities' of a FINRA member may apply to claims involving non-securities."<sup>159</sup> The district court nonetheless granted a preliminary injunction of the arbitration to allow for resolution of the outstanding factual issues, which was affirmed by the Second Circuit.<sup>160</sup> As the Second Circuit described the holding of *Citigroup* in a later case, "Where there is a genuine dispute as to the role played by the FINRA member in connection with a credit default swap, a trial will be required."<sup>161</sup>

By comparison, in *Wachovia Bank*, the Second Circuit concluded that where a broker-dealer's representatives participated in a transaction but did not recommend the transaction or otherwise have any "advisory, brokerage, or other fiduciary relationship," the provision of business services will not give rise to a customer relationship.<sup>162</sup> In *Wachovia Bank*, unlike *Citigroup*, VCG did not

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153. 598 F.3d 30, 39 (2d Cir. 2010).

154. 661 F.3d 164, 172–74 (2d Cir. 2011), *cert. denied*, 132 S. Ct. 2439 (2012).

155. *Citigroup*, 598 F.3d at 33.

156. *Id.*

157. *Id.*

158. *Citigroup Global Mkts. Inc. v. VCG Special Opportunities Master Fund Ltd.*, No. 08-CV-5520 (BSJ), 2008 WL 4891229, at \*4 (S.D.N.Y. Nov. 12, 2008), *aff'd*, 598 F.3d 30 (2d Cir. 2010).

159. *Id.* at \*5.

160. *Citigroup*, 598 F.3d at 32.

161. *Wachovia Bank, Nat. Ass'n v. VCG Special Opportunities Master Fund, Ltd.*, 661 F.3d 164, 173 (2d Cir. 2011).

162. *Id.* at 174.

have a preexisting brokerage relationship with Wachovia, the parties expressly disclaimed any advisory relationship, and VCG admitted that “Wachovia did not recommend the deal to VCG.”<sup>163</sup> Accordingly, the court noted that because “there is no factual issue as to whether [Wachovia Bank] provided advice, recommendations, or other services to VCG,” “there is no need to grapple with the precise boundaries of the FINRA meaning of ‘customer.’”<sup>164</sup> The court was confident that on these facts “no rational factfinder could infer that VCG was a customer of WCM.”<sup>165</sup>

Finally, in *Twenty-First Securities Corp. v. Crawford*, an investor sought advice from a FINRA member about income-yielding investments, although the investor intended to buy the investments independently.<sup>166</sup> The FINRA member sent materials to the investor and received a “solicitation fee” from the chosen fund once the investor invested.<sup>167</sup> On these facts, the court had no trouble concluding that the plaintiff “was a customer of Twenty-First because he received investment advice from Gordon its president,” who received compensation for the plaintiff’s purchase.<sup>168</sup> The fact that the FINRA member did not execute the transaction or otherwise hold the plaintiff’s securities or account did not prevent a finding that the plaintiff was a customer entitled to arbitrate.<sup>169</sup>

#### *D. Customers of Predecessor or Successor Members*

Apart from the question of what relationship is sufficient to create customer status, courts have also addressed timing issues regarding customer status. What if the investor conducts business with a predecessor entity? Can the investor claim customer status as to the current firm, even if the conduct complained about occurred previously?

The principal case addressing this issue is *Wheat, First Securities, Inc. v. Green*.<sup>170</sup> In *Wheat*, the investors had been customers of Marshall Securities when they alleged they were fraudulently induced to purchase investments.<sup>171</sup> “Well after the allegedly fraudulent . . . transactions occurred,” *Wheat, First Securities Inc.* purchased

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163. *Id.*

164. *Id.*

165. *Id.*

166. No. 11 Civ. 6406(WHP), 2011 WL 6326128, at \*1 (S.D.N.Y. Dec. 15, 2011), *aff’d*, 502 F. App’x 64 (2d Cir. 2012).

167. *Id.*

168. *Id.* at \*2.

169. *Id.* at \*3.

170. 993 F.2d 814, 820–21 (11th Cir. 1993).

171. *Id.* at 815.



Marshall Securities.<sup>172</sup> After the merger, the investors' accounts were transferred from Marshall to Wheat, First.<sup>173</sup> The investors sought to bring arbitration against Wheat, First, arguing that as current customers of Wheat, First they could seek arbitration based on conduct that occurred while they invested with the predecessor company.<sup>174</sup>

The Eleventh Circuit rejected this theory based on a contractual analysis of the "reasonable expectations of NASD members."<sup>175</sup> The court concluded that no reasonable NASD member could expect that NASD membership would require it to "arbitrate claims which arose while a claimant was a customer of another member merely because the claimant subsequently became its customer."<sup>176</sup> The court held that customer status "must be determined as of the time of the events providing the basis for the allegations of fraud."<sup>177</sup> Because they were not yet a customer at the time of the transactions, "they cannot invoke the NASD Code to compel Wheat, First to arbitrate."<sup>178</sup>

Subsequent cases have limited *Wheat* where although the fraudulent purchase occurred before the investor became a customer of the broker-dealer, the events giving rise to the claim continued into the period where the investor was a customer of the broker-dealer or where there are allegations of related misconduct that occurred after the investor became a customer of the broker-dealer. Thus, in *O.N. Equity Sales Co. v. Gibson*, although the investor purchased an initial offering from a broker before he became affiliated with the FINRA member, the investment was held in escrow until after the broker became affiliated with the member, and the offering was materially modified after the broker became affiliated with the member.<sup>179</sup> The court held that where some facts giving rise to liability occurred during the period the broker was affiliated with the FINRA member,

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172. *Id.* at 816.

173. *Id.*

174. *Id.*

175. *Id.* at 820.

176. *Id.*

177. *Id.*

178. *Id.* See also *Gruntal & Co., Inc. v. Steinberg*, 854 F. Supp. 324, 340 (D.N.J. 1994), *aff'd*, 46 F.3d 1116 (3d Cir. 1994) ("[T]he misconduct which is the subject of the Arbitration Proceedings took place, in its entirety, at least two months before the Steinbergs became customers of Gruntal. Because these acts were committed when the Steinbergs were not customers of Gruntal, Gruntal cannot be compelled to arbitrate with the Steinbergs by virtue of the NASD Code of Arbitration Procedure." (citations omitted)).

179. 514 F. Supp. 2d 857, 864 (S.D. W. Va. 2007).

the investor was a customer who could seek arbitration of the claims.<sup>180</sup>

The issue of whether an investor can be a customer of their broker’s former broker–dealer firm was presented in *SII Investments, Inc. v. Jenks*.<sup>181</sup> In *Jenks*, an investor claimed that her broker fraudulently advised her to invest in a newly-formed company, the stock of which was not yet available.<sup>182</sup> After the broker left the broker–dealer firm, the investment became available and the investor purchased the investment.<sup>183</sup> After the investment turned sour, the investor sought arbitration against SII Investments, her broker’s former firm.<sup>184</sup>

The court in *Jenks* began its analysis with *Wheat* but found that it was distinguishable because in *Wheat* the investor had no relationship with the FINRA member at the time of the investment, whereas in *Jenks* the investor had an existing relationship and her claims were based in part on misrepresentations made while her broker was at SII Investments. Notably, the court focused on the date the representations were alleged to have occurred, rather than the date that damages were sustained.<sup>185</sup> Because the purchases “grew out of and were a natural consequence of” the broker’s misrepresentations while at SII, the investor “was SII’s customer at the time of the events providing the basis for the allegations of her claims.”<sup>186</sup>

#### IV. DEFINITIONS OF “CUSTOMER”

As demonstrated in the survey in Section III of the decisions that have addressed the term “customer,” courts have generated several different definitions of “customer” under Rule 12200. This Section lays out four of the main definitions of “customer” that have been embraced by courts, with an eye toward identifying the drawbacks in each definition.

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180. *Id.* See also *World Grp. Sec., Inc. v. Sanders*, No. 2:06-CV-00107 PGC, 2006 WL 1278738, at \*4–5 (D. Utah May 8, 2006) (finding that investor was customer where her claims involved not only fraudulent conveyance at a predecessor broker–dealer but also negligent supervision at the defendant broker–dealer during a period when she was a customer).

181. 370 F. Supp. 2d 1213, 1217–19 (M.D. Fla. 2005).

182. *Id.* at 1214–15.

183. *Id.* at 1216.

184. *Id.* at 1214.

185. *Id.* at 1218.

186. *Id.* at 1219.

A. “*Shall Not Include a Broker or Dealer*”

This definition, which has the advantage of being specifically included in the FINRA rules, has been largely rejected by courts as an adequate definition. Even those courts that appear to have decided customer cases based on little beyond this definition, such as the *John Hancock* court,<sup>187</sup> have felt compelled to cite the general interpretive rule that all doubts about the scope of an arbitration provision must be construed in favor of arbitration.<sup>188</sup>

The FINRA provision is unsatisfying because, among other things, it does not purport to exhaustively define the term “customer.” “Shall not include” does not require, as matter of logic, that everything not listed be included.

A deeper look at the structure of the FINRA rules suggests that the FINRA definition of “customer” is not meant to define who can invoke Rule 12200 but instead is meant to clarify which of FINRA’s two sets of arbitration procedures applies to disputes between FINRA members. FINRA’s Code contains two largely parallel sets of arbitration provisions: one for customer disputes and one for industry disputes.<sup>189</sup> The negative definition of customer, which mostly affects FINRA members only, clarifies that the Industry Code applies to all disputes between FINRA members, even if one member could be considered a customer of the other in the subject transaction. On this reading, the definition was never meant to identify the scope of parties who could invoke the FINRA forum under Rule 12200 but rather was meant to exclude FINRA members from arbitrations under the customer rules.

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187. *John Hancock Life Ins. Co. v. Wilson*, 254 F.3d 48, 59–60 (2d Cir. 2001). The Second Circuit later described its decision in *John Hancock* as “avoid[ing] offering an exhaustive definition of the term [customer].” *UBS Fin. Servs., Inc. v. W. Va. Univ. Hosps., Inc.*, 660 F.3d 643, 650 (2d Cir. 2011) (citation omitted).

188. See *John Hancock*, 254 F.3d at 59 (citing *Moses H. Cone Mem’l Hosp. v. Mercury Const. Corp.*, 460 U.S. 1, 24–25 (1983) (“The Arbitration Act 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.”)).

189. Compare FINRA R. 12100–12905 (2013), available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=4096](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4096) (Code of Arbitration Procedure for Customer Disputes) with FINRA R. 13100–13905 (2013), available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=4193](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4193) (Code of Arbitration Procedure for Industry Disputes).

*B. “One Who Receives Investment and Brokerage Services”*

In *Fleet Boston*, the Eighth Circuit almost in passing created a definition of “customer” as “one who receives investment and brokerage services” that was widely cited by courts around the country.<sup>190</sup> Ironically, although the reference to “investment and brokerage services” is the section most widely cited, the full context of the Eighth Circuit’s quote makes clear that it did not mean to restrict the definition solely to the recipients of investment and brokerage services: “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.*”<sup>191</sup> The Eighth Circuit’s holding excluded financial advice from the relationships that would give rise to a customer relationship, and the Eighth Circuit clarified that it was not rejecting the Third Circuit’s analysis in *Patten*, which held that an issuer was a customer of its underwriter.<sup>192</sup> So the Eighth Circuit explicitly did not limit the definition of “customer” solely to investment or brokerage relationships.

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190. *Fleet Boston Robertson Stephens, Inc. v. Innovex, Inc.*, 264 F.3d 770, 772 (8th Cir. 2001). *See, e.g.*, *Morgan Keegan & Co. v. Shadburn*, 829 F. Supp. 2d 1141, 1148 (M.D. Ala. 2011) (“[T]he Eighth Circuit held that a ‘customer’ is one who ‘receive[s] investment or brokerage related services, from an NASD member,’ . . . .” (alteration in original)); *Zarecor v. Morgan Keegan & Co.*, No. 4:10CV01643 SWW, 2011 WL 5592861, at \*4 (E.D. Ark. July 29, 2011) (“The Eighth Circuit affirmed, finding that the term ‘customer’ under Rule 12200 ‘refers to one involved in a business relationship with [a FINRA] member that is related directly to investment or brokerage related services.’” (alteration in original) (citation omitted)); *Oppenheimerfunds Distrib., Inc. v. Liska*, No. 11-CV-1586 BEN (WMC), 2011 WL 5984036, at \*3 (S.D. Cal. Nov. 28, 2011) (“When the relationship between the parties is more tenuous, the court should determine whether there is ‘some brokerage or investment relationship between the parties.’”); *O.N. Equity Sales Co. v. Rahner*, 526 F. Supp. 2d 1195, 1201 (D. Colo. 2007) (“The Eighth Circuit, relying upon various other NASD Rules, concluded that to be a ‘customer’ for purposes of Rule 10301, an individual must be ‘involved in a business relationship with an NASD member that is related directly to investment or brokerage services.’” (citation omitted)); *Morgan Keegan & Co., Inc. v. Louise Silverman Trust*, Civil No. JFM-11-2533, 2012 WL 113400, at \*3 (D. Md. Jan. 12, 2012), *aff’d sub nom*, *Morgan Keegan & Co., Inc. v. Silverman*, 706 F.3d 562 (4th Cir. 2013) (“[T]he Eighth Circuit Court of Appeals interpreted ‘customer’ to mean an individual who is ‘involved in a business relationship with [a FINRA] member that is related directly to investment or brokerage related services.’” (footnote omitted) (citation omitted)).

191. *Fleet Boston*, 264 F.3d at 772 (emphasis added).

192. *See id.* at 773 n.3 (“Although the relationship between the two [in *Patten*] was not a broker/investor relationship, it still related directly to the issuance of securities, rather than banking advice, and is thus unavailing here.”).

A definition of “customer” limited to investment or brokerage relationships is clearly not derived from the text of the FINRA rule, which references only “business activities” and an exclusion of “insurance.” Such a definition is also not derived from the scope of FINRA’s regulatory activities, which exceed investments and broker-dealing, as demonstrated by the issuer decisions.<sup>193</sup> A decision limiting “customer” to investment or brokerage relationships would graft an unwarranted judicial gloss on the rules of an arbitral forum, locking some parties out of FINRA arbitration without any compelling reason. Luckily, most cases citing *Fleet Boston* for this proposition have been cases concerning privity rather than the scope of business activities that give rise to a customer relationship.<sup>194</sup> The authors are not aware of a case that cites *Fleet Boston* to actually limit FINRA arbitration to investment or brokerage relationships to the exclusion of other FINRA-regulated relationships.

C. “One Who Buys Goods or Services”

The Second Circuit, in *West Virginia University Hospitals*, proposed a “core definition” of “customer” as “one who buys goods or services.”<sup>195</sup> It reached this result primarily based on the dictionary,<sup>196</sup> as well as the general agreement of the parties.<sup>197</sup> And it admitted in the decision that it was not attempting to “provide a comprehensive definition of the term under Rule 12200.”<sup>198</sup>

Like the negative FINRA definition, this definition seems overbroad. Although the Eighth Circuit’s investment or brokerage gloss is an arbitrary judicial creation, it at least rationalizes “customer” by limiting it to a range of the activities FINRA regulates.

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193. See *Patten Sec. Corp. v. Diamond Greyhound & Genetics, Inc.*, 819 F.2d 400, 406 (3d Cir. 1987) (citing interpretive statement of the NASD’s National Arbitration Committee for “[a]n issuer of securities should be considered a public customer of a member firm where a dispute arises over a proposed underwriting”).

194. See, e.g., *Shadburn*, 829 F. Supp. 2d at 1150–51; *Zarecor*, 2011 WL 5592861, at \*4–5; *Liska*, 2011 WL 5984036, at \*2–5; *Rahner*, 526 F. Supp. 2d 1195 at 1200–02; *Louise Silverman Trust*, 2012 WL 113400, at \*3.

195. *UBS Fin. Servs., Inc. v. W. Va. Univ. Hosps., Inc.*, 660 F.3d 643, 650 (2d Cir. 2011) (“The term ‘customer’ includes at least a non-broker or non-dealer who purchases, or undertakes to purchase, a good or services from a FINRA member.”).

196. The Second Circuit cited both *Webster’s Third New International Dictionary* (3d ed. 2002) and *American Heritage Dictionary of the English Language* (4th ed. 2000).

197. *W. Va. Univ. Hosps.*, 660 F.3d at 650 (“UBS asserts, and the parties conceded at oral argument, that ‘customer’ means ‘someone who buys goods or services.’”).

198. *Id.*

The Second Circuit’s definition, if taken literally, might allow arbitration to be demanded by a corporation that leases space from a FINRA member or rents back office support. The Second Circuit surely did not mean to cover such “goods or services” and would be very unlikely to allow arbitration if such an issue arose in front of them.

*D. “One Who Purchases Commodities or Services that Are Regulated by FINRA”*

The Fourth Circuit, in *Carilion*, proposed the most comprehensive definition:

“Customer,” as that term is used in the FINRA Rules, 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.<sup>199</sup>

The same decision went on to hold that an issuer will ordinarily be a customer of its underwriter, demonstrating that the Fourth Circuit’s understanding of “investment banking and securities business activities” is likely broader than the “investment and brokerage services” contemplated by the Eighth Circuit.<sup>200</sup> The Fourth Circuit applied this same definition in *Silverman and Raymond James*, which clarified that the purchase must be directly from the FINRA member so that privity is required to claim customer status.<sup>201</sup>

Of the various definitions proposed by courts, the Fourth Circuit’s has the advantage of harmonizing the ordinary understanding of “customer”—one who purchases something—with the purpose of FINRA arbitration—to resolve disputes that arise within the scope of FINRA’s regulatory authority. Rather than artificially limit FINRA arbitration to a judicially preferred set of activities like investment and brokerage services, the limitation is set by FINRA’s own scope. It also provides the right to FINRA arbitration for those customers most likely to need it: If the transaction a customer is executing is within the scope of activities regulated by FINRA, the customer will be entitled to demand arbitration.

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199. *UBS Fin. Servs., Inc. v. Carilion Clinic*, 706 F.3d 319, 327 (4th Cir. 2013).

200. *Id.* at 326–27.

201. *Morgan Keegan & Co., Inc. v. Silverman*, 706 F.3d 562, 566–67 (4th Cir. 2013); *Raymond James Fin. Servs., Inc. v. Cary*, 709 F.3d 382, 386–87 (4th Cir. 2013).

Relying on the scope of FINRA-regulated activity makes the Fourth Circuit's rule slightly more difficult to apply than simply looking at whether the putative customer purchased something or is not a broker or dealer. Yet it avoids the absurd situations that arise under an extremely broad rule. The parties to a FINRA arbitration, which always includes at least one member, should also be well equipped to determine whether or not the transaction was within FINRA's regulatory scope, somewhat lessening the difficulty of applying this definition.

#### CONCLUSION

As noted above, courts have employed a wide array of definitions and analyses when determining whether or not a claimant falls within FINRA's definition of "customer" and thus can demand arbitration under FINRA Rule 12200. If the SEC soon bans the use of PDAs in brokerage agreements, as it is granted the discretion to do under the Dodd-Frank Act and as members of Congress are requesting,<sup>202</sup> arbitration of consumer securities disputes may soon be largely at the voluntary demand of customers of FINRA members. Who is—or is not—deemed a "customer" will be crucial for determining the forum that resolves securities disputes. As such, it is now vitally important for courts to arrive at a clear and concise definition of what it means to be a "customer" of a FINRA member. Rather than allow the confusion over interpreting the term to continue, other federal circuits should adopt the Fourth Circuit's definition of "customer" because it provides certainty to the parties and serves the general purpose of FINRA.

Adopting the Fourth Circuit's "customer" analysis will create a comprehensive definition of who can demand arbitration in FINRA, providing certainty to both customers and the FINRA members who do business with them. This uniform approach will increase efficiency in the filing of arbitrations, decreasing the number of times that customers are dragged into federal court to litigate whether they are actually customers of the FINRA member.<sup>203</sup> This certainty will also allow both customers and FINRA members to better arrange their business relationships because they can anticipate the proper forum and its procedural rules. FINRA members need to know which of their activities, and activities with whom, will give rise to the customer relationship. Clients of FINRA members similarly need clear guidance on precisely when they are entitled to demand arbitration. The Fourth Circuit's definition of "customer" provides the

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202. See discussion *supra* note 13.

203. See discussion *supra* note 7 and accompanying sources.

type of certainty necessary for parties to move forward efficiently and effectively toward resolving their securities disputes.

Most importantly, adopting the Fourth Circuit’s rule on the parameters of a FINRA “customer” will serve the purpose of FINRA because it will ensure non-FINRA members who interact with FINRA-regulated entities that they will have a forum for efficient resolution of securities disputes.<sup>204</sup> FINRA’s mission statement is very broad, reaching well beyond simply protecting investors: “FINRA is dedicated to investor protection and market integrity through effective and efficient regulation of the securities industry.”<sup>205</sup> A more comprehensive definition of “customer” will advance FINRA’s mission and the interests of all those FINRA oversees: its members, the customers of those members, and the securities industry as a whole.

Know your customer, the old adage goes.<sup>206</sup> Resolution of this issue is necessary so that FINRA members can truly know who their customers are.

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204. See *Carilion*, 706 F.3d at 327. As the Fourth Circuit stated in upholding a broad interpretation of the term “customer”:

UBS and Citi argue that our holding is inconsistent with FINRA’s stated purpose of “protecting investors.” As we have already pointed out, however, even though FINRA undertakes in its mission to protect investors, it also serves a broader purpose, that of serving as “the sole self-regulatory organization chartered under the Exchange Act to exercise comprehensive oversight of the securities industry.” Its mission includes the specific purpose of promoting observance of federal and state securities laws and investigating and adjusting grievances between the public and FINRA members under those laws. FINRA Rule 12200 serves that mission.

*Id.* (citations omitted).

205. See *About the Financial Industry Regulatory Authority*, FINRA, <http://www.finra.org/AboutFINRA/> (last visited Sept. 8, 2013).

206. This old adage has been specifically codified into the FINRA rules as one of the critical cogs in FINRA’s regulation of brokers and dealers. See FINRA Rule 2090 (2013), available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=9858](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9858); FINRA, REGULATORY NOTICE 11-02, KNOW YOUR CUSTOMER AND SUITABILITY 1 (2011), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p122778.pdf> (“The know-your-customer and suitability obligations are critical to ensuring investor protection and promoting fair dealing with customers and ethical sales practices.”). See generally Genci Bilali, *Know Your Customer—Or Not*, 43 U. TOL. L. REV. 319, 327 (2012) (outlining the role of “Know Your Customer” rules in securities regulation).