COMMERCIAL & BUSINESS LITIGATION
AMERICAN BAR ASSOCIATION SECTION OF LITIGATION

CIRCUIT NOTES: FOURTH CIRCUIT

Fourth Circuit Defines "Customer"

UBS Financial Services, Inc. v. Carilion Clinic, No. 12-2066 (4th Cir. Jan. 23, 2013)
Morgan Keegan & Co. v. Silverman, No. 12-1208 (4th Cir. Feb. 4, 2013)

The Fourth Circuit has, for the first time, defined who is a "customer" for purposes of FINRA [Financial Industry Regulatory Authority] rules that entitle customers of a securities firm to demand arbitration. The court held that a "customer" is "one, not a broker or dealer, who purchases commodities or services from a FINRA member in the course of the member's business activities insofar as those activities are regulated by FINRA—namely investment banking and securities business activities." The court then applied that definition in two cases, with opposite results.

In the first case, *UBS Financial Services, Inc. v. Carilion Clinic*, Carilion retained UBS and Citi as investment advisers in connection with a bond offering. UBS and Citi provided various services to Carilion, including advising on the structure of the financing, serving as underwriters for the bonds, and acting as Carilion's agent in dealing with rating agencies. Later, the market for Carilion's bonds collapsed, forcing Carilion to refinance and thereby lose millions of dollars. Carilion, claiming that these losses were caused by UBS and Citi's malfeasance, initiated arbitration proceedings with FINRA pursuant to FINRA Rule 12200, which requires FINRA members (including UBS and Citi) to arbitrate disputes between themselves and a "customer" if requested by the customer.

UBS and Citi sought to enjoin the arbitration, contending that Carilion was not a "customer" within the meaning of Rule 12200 because that rule was intended to protect investors rather than issuers such as Carilion. The Fourth Circuit rejected this argument on the grounds that: (a) the ordinary meaning of "customer" includes all products offered by a company, and (b) nothing in the FINRA rules limit "customers" to investors. Thus, by purchasing underwriting and auction services from UBS and Citi, Carilion was a customer for purposes of Rule 12200.

UBS and Citi further contended that even if Carilion was a customer, Carilion waived its right to arbitration by contractually agreeing to a forum selection clause providing that "all actions and proceedings arising out of this Agreement . . . shall be brought in the United States District Court in the County of New York." Addressing this argument, the court acknowledged that the obligation to arbitrate under Rule 12200 can be superseded and displaced by a more specific agreement between the parties. The Court added, however, that any such agreement "must be sufficiently specific to impute to the contracting parties the reasonable expectation that they are superseding, displacing, or waiving the arbitration obligation created by FINRA Rule

12200." The court then held that the forum selection clause in this case, which says nothing about arbitration, was not sufficiently specific to show an intent to waive Rule 12200.

Two weeks later, in *Morgan Keegan & Co. v. Silverman*, the Fourth Circuit again addressed the definition of "customer" under FINRA Rule 12200. Defendants invested in bond funds that were distributed and underwritten by FINRA member Morgan Keegan. The defendants did not purchase the funds directly from Morgan Keegan, but rather on the secondary market through their brokerage account at Legg Mason. The value of the funds dropped in 2007, causing the defendants to lose money. The defendants initiated FINRA arbitration proceedings against Morgan Keegan, alleging that Morgan Keegan failed to disclose information about the high-risk nature of the funds and falsely inflated the funds' asset values.

Morgan Keegan sought to enjoin the arbitration on the grounds that the defendants were not its "customers" under Rule 12200 and therefore not entitled to demand arbitration. The Fourth Circuit, applying the definition of "customer" from the *UBS* case, held in Morgan Keegan's favor on the grounds that the defendants did not "purchase commodities or services" from Morgan Keegan. Rather, the defendants' relationship was with their broker, Legg Mason. The court explained that merely having "a remote association with alleged misconduct falling within the general ambit of FINRA's regulatory interests" is insufficient to create a customer relationship for purposes of Rule 12200.

These cases together show that a "customer" for purposes of FINRA arbitration rules must have a direct relationship with the securities firm at issue, but once such a relationship is established, the right to arbitrate is broad enough to cover disputes relating to most commodities or services offered by a securities firm.

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