LAW360

Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

2nd Circ. To Test Flexibility Of FINRA Arbitration Rule

By **Stephanie Russell-Kraft**

Law360, New York (April 17, 2014, 8:32 PM ET) -- A Connecticut hedge fund faces an uphill battle in the Second Circuit next week in a bid to overturn a district court's narrow definition of "customer" under the Financial Industry Regulatory Authority's arbitration rules despite FINRA's open-ended interpretation of the term, attorneys say.

U.S. District Judge Naomi Reice Buchwald ruled in May that Turnberry Capital Management LP couldn't force SunTrust Banks Inc. into arbitration in a mortgage-backed securities dispute because it wasn't SunTrust's customer. Turnberry has argued SunTrust was the one actually peddling the toxic certificates and that broker Raymond James Associates Inc., from which Turnberry bought the securities, was merely a pass-through entity.

Under the independent securities regulator's current arbitration rules, customers in dispute with FINRA-registered broker dealers have the right to compel arbitration. But FINRA's open-ended definition — that a "customer shall not include a broker or dealer" — has left the courts to decide how far the right to arbitration extends.

"The field is open for a rethinking," said Kevin O'Brien of Harris O'Brien St. Laurent & Houghteling LLP, counsel for Turnberry. "The Second Circuit has an opportunity to clarify the proper approach to determining what a customer is, and the best way to give effect to the core mission of FINRA, which is protecting investors. That's a question they really haven't addressed directly and we think they should."

According to court documents, the SunTrust dispute stems back to 2007, when Raymond James allegedly told Turnberry it could purchase certificates placed in a trust based on a pool of residential mortgage loans aggregated by the SunTrust affiliate. After Turnberry lost $13 million in the process, it argued it had relied on investment documents provided by both SunTrust and Raymond James, and that it should be treated as a SunTrust customer under FINRA rules.

Turnberry claims it has the right to arbitrate its claims against SunTrust since both Raymond James and SunTrust are FINRA members. By allowing SunTrust to avoid arbitration, the Second Circuit would effectively allow banks to insulate themselves from arbitration liability by using brokers to protect themselves, according to O'Brien.

O'Brien also pointed to a separate case regarding the same FINRA rule, Citigroup Global Markets Inc. v. Abbar, which he said also threatens investors' rights to arbitration. A Saudi investor on May 16 will challenge a New York district judge's May 2013 decision requiring a customer of a broker-dealer to

maintain “an account” with a firm and make a purchase of securities from it in order to arbitrate his or her disputes in a FINRA arbitration.

The Public Investors Arbitration Bar Association, weighing in on that case, has argued that the district judge’s ruling harmed the “efficient, timely and inexpensive resolution of disputes” offered to FINRA members and their customers via arbitration.

But according to Jenice Malecki, an attorney for PIABA, the Turnberry case is different. She said the district court properly applied prevailing Second Circuit law when it found Raymond James shielded SunTrust from arbitration by acting as Turnberry’s broker.

“While Turnberry apparently relied upon writings created by SunTrust, SunTrust did not make a recommendation to buy to Turnberry,” Malecki said.

SunTrust may be a FINRA-registered broker-dealer, but it isn’t Turnberry’s broker-dealer, according to Rimma Tsvasman of Montgomery McCracken Walker & Rhoads LLP.

“If SunTrust was not acting in its capacity as broker-dealer, can we really say that it has agreed or submitted itself to arbitration in a case like this?” Tsvasman asked.

Although SunTrust admitted that the Second Circuit hasn’t yet “comprehensively defined” the term "customer," it argued in a November brief that the term unambiguously requires the direct purchase of a good or service from the FINRA member in question. FINRA’s arbitration rule doesn’t extend to SunTrust in its capacity as an underwriter, the bank has argued.

“I can’t see the court extending the definition of 'customer' that far,” said David E. Robbins of Kaufmann Gildin & Robbins LLP, who believes it is up to FINRA to expand that term.

Christopher B. Wells of Lane Powell PC, who said Turnberry is pushing for arbitration because it’s such a better venue for dispute resolution, also thinks the hedge fund is facing bad odds in the Second Circuit.

“If you’re a customer and you purchase Apple and you think that Apple deceived you, you don’t call Apple into FINRA arbitration,” he said. “I find it hard to believe that the courts would allow a customer to skip through the tiers of the distribution of a security.”

But according to O’Brien, the real issue at stake is a question of policy: how far the courts are willing to go to broaden investors’ access to the arbitration process. He said the court should consider the practical consequences for Turnberry and similar plaintiffs when it makes its decision, a sentiment echoed by Glenn Gitomer, chairman of the securities litigation group at McCausland Keen & Buckman, who said Turnberry will face cumbersome parallel litigation in both arbitration and court if the district court’s decision is upheld.

“That’s an extraordinarily inefficient way to litigate claims,” he said. “It just doesn’t seem a practical way to come to a fair and just resolution of the dispute.”

Indeed, rather than the FINRA rule itself, the court may be ruling on the ease of access customers have to redress their concerns in arbitration hearings, which are far more favorable to plaintiffs than the courts, according to Andrew Goodman, chairman of the East Coast litigation group and the firmwide litigation task force for Garvey Schubert Barer and veteran arbitrator.

“Given the Supreme Court’s continuing pro-arbitration tilt, the circuit’s decision is not likely to be the last word,” Goodman said.

Counsel for SunTrust did not respond to a request for comment.

SunTrust is represented by Paul A. Straus, Cory Hohnbaum and David Guidry of King & Spalding LLP.

Turnberry is represented by Kevin O’Brien of Harris O'Brien St. Laurent & Houghteling LLP.

The case is SunTrust Banks Inc. et al. v. Turnberry Capital Management LP et al., case number 13-2075, in the U.S. Court of Appeals for the Second Circuit.

--Additional reporting by Kurt Orzeck and Sindhu Sundar. Editing by Jeremy Barker and John Quinn.

All Content © 2003-2014, Portfolio Media, Inc.