SULLIVAN & CROMWELL LLP

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# Second Circuit Adopts Bright-Line Rule For Determining Customer Status For Mandatory FINRA Arbitration

## Court Rules that for Purposes of Demanding FINRA Arbitration, "Customers" of FINRA Members Are Those Who Either Purchase a Good or Service from a FINRA Member or Have an Account with a FINRA Member

### SUMMARY

On Friday, August 1, 2014, the Second Circuit issued its decision in *Citigroup Global Markets, Inc.* v. *Abbar*, No. 13-2172 (2d Cir. Aug. 1, 2014), a case addressing the Financial Industry Regulatory Authority rule that FINRA members must consent to mandatory arbitration of disputes with any "customer" that arise in connection with the member's business activities. The case presented the question whether an investor's extensive contacts with a FINRA member rendered that investor a "customer" of the FINRA member for purposes of demanding FINRA arbitration, even though the investor had not consummated a transaction or opened an account with the FINRA member. Affirming the district court's judgment, the Second Circuit ruled that for purposes of FINRA arbitration, a "customer" of a FINRA member is one who, while not a broker or dealer, either (1) purchases a good or service from a FINRA member or (2) has an account with a FINRA member.[1] In the past, courts have taken a variety of approaches to defining customer status for purposes of FINRA arbitration, often involving fact-intensive inquiries and leading to uncertain outcomes. The decision provides a clear and administrable bright-line rule for when a party is a customer of a FINRA member and thus entitled to compel arbitration. The Second Circuit's decision provides greater predictability as to the dispute resolution mechanism and forum applicable to securities-industry disputes, while acknowledging that exceptions may be compelled in rare instances to avoid injustice.[2]

## BACKGROUND

The dispute giving rise to Friday's decision grew out of complex options transactions a Saudi family—the Abbars—entered into with Citigroup Global Markets Ltd. (Citi UK), which is incorporated in the United Kingdom and is not a FINRA member. Citi UK was the counterparty to the agreements with the Abbar family, but the Abbar family managed its investments with help from Citigroup Global Markets, Inc. (Citi NY), a FINRA member incorporated under the laws of New York. Employees of Citi NY worked on negotiating and structuring the options transactions, and Citi NY held certain voting rights as to those transactions. Despite the Abbar family's extensive interactions with Citi NY, they never consummated a transaction or opened an account with Citi NY. The option transactions and agreements were executed between Citi UK and the Abbar family and recorded as accounts in Citi UK's books.

In 2008, the option transactions began performing poorly, and by 2009 the Abbar family had lost the entire investment. Although the option transaction agreements themselves did not contain choice-of-law or forum-selection clauses, two structuring-services letters to which the Abbar family agreed provided for disputes to be adjudicated in English courts under English law. Nonetheless, in August 2011, the Abbar family commenced a FINRA arbitration against Citi NY. They relied on Rule 12200 of the FINRA Code of Arbitration Procedure for Customer Disputes, which allows any "customer" of a FINRA member to require the member to arbitrate the customer's claims against the member so long as the dispute arises in connection with the member's business activities. FINRA's customer arbitration code, however, does not define the term "customer," other than to specify that a "customer shall not include a broker or dealer."[3] The Abbar family claimed that it was a "customer" not just of Citi UK but of Citi NY as well.

Citi NY sued to enjoin the arbitration, arguing that the Abbar family was not a "customer" of Citi NY for purposes of Rule 12200 and could not force Citi NY to arbitrate the dispute before FINRA. The parties litigated the issue whether the Abbar family was a customer of Citi NY for some two years, culminating in a nine-day trial. After the trial, though, the trial court ruled that, rather than requiring such a fact-intensive inquiry, a bright-line rule as to "customer" status would be "more direct, available, reliable, and predictable." For this bright-line rule, the court looked to the touchstones of a member-customer relationship: the opening of an account and the execution of a transaction. The trial court explained that "[t]he elements of an account and a purchase are visible to all at the outset of the dispute resolution process" and allow for "ready determination of the arbitrability of disputes" without "the need for lengthy proceedings."[4] As the Abbar family had neither maintained an account nor executed a transaction with Citi NY, the trial court enjoined the family's FINRA arbitration.

## THE SECOND CIRCUIT'S DECISION

The Second Circuit affirmed the district court's decision permanently enjoining the arbitration and ruled "that a 'customer' under FINRA Rule 12200 is one who, while not a broker or dealer, either (1) purchases

a good or service from a FINRA member, or (2) has an account with a FINRA member."[5] The court of appeals emphasized the value of a bright-line rule: "The only relevant inquiry in assessing the existence of a customer relationship is whether an account was opened or a purchase made; parties and courts need not wonder whether myriad facts will 'coalesce into a functional concept of the customer relationship.'"[6] After discussing the extensive interactions between the Abbar family and Citi NY and the trial court's exhaustive review of those interactions, the court of appeals pointed to the proceedings below as evidencing the need for a bright-line rule, observing that "[t]he sprawling litigation that can (and did) result defeats the express goals of arbitration to economical and swift outcomes."[7]

In adopting this bright-line rule, the court of appeals noted that FINRA could police "evasion and abuse" through its power to discipline its members and to adjust its rules. The court of appeals also endorsed the trial court's "caveat that exceptions may be compelled in rare instances of injustice."[8]

## IMPLICATIONS

For plaintiffs, one attraction of FINRA arbitration is that it provides defendants less opportunity to have a dispute dismissed before proceeding to the merits than court cases generally afford. This feature has led plaintiffs to press for expansive interpretations of what it means to be a FINRA member's "customer," which has in turn given rise to litigation over whether a particular party qualifies. The Second Circuit's holding provides securities-market participants a valuable measure of clarity and predictability by supplying an easily administrable standard that allows parties to predict with reasonable certainty whether their dispute is subject to FINRA's mandatory arbitration provisions. Prior to Friday, that question was the subject of substantial uncertainty, and its resolution often required burdensome, time-consuming, and fact-intensive discovery and judicial scrutiny. At least in cases arising within the Second Circuit—Connecticut, New York and Vermont—the inquiry will now be much simpler and more predictable. Moreover, the many FINRA-member financial institutions based in New York now have greater certainty that they can assist their foreign affiliates in work for the affiliates' customers without creating a member-customer relationship with the affiliates' customers. It was these benefits that Citi NY and *amicus curiae* the Securities Industry and Financial Markets Association emphasized in seeking adoption of a bright-line rule.[9]

By adopting the rule first articulated in the trial court, the Second Circuit has taken a substantial step toward ensuring that courts in that circuit enforce agreements among participants in the securities industry reflecting their choice of forum for the resolution of disputes—whether that choice is arbitration, litigation, or some other means. Although we expect there to be future litigation as to whether particular cases are the "rare instances of injustice" justifying deviation from the bright-line rule, the rule provides important clarity in an area that was previously rather murky.

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## ENDNOTES

[1] *Citigroup Global Markets, Inc.* v. *Abbar*, No. 13-2172, slip op. at 17 (2d Cir. Aug. 1, 2014).

[2] *Id.* at 19.

[3] FINRA Rule 12100(i).

[4] *Citigroup Global Markets, Inc.* v. *Abbar*, 943 F. Supp. 2d 404, 410 (S.D.N.Y. 2013).

[5] *Citigroup Global Markets, Inc.* v. *Abbar*, No. 13-2172, slip op. at 17.

[6] *Id.* at 19 (quoting *Citigroup Global Markets, Inc.* v. *Abbar*, 943 F. Supp. 2d at 407).

[7] *Id.* at 20.

[8] *Id.* at 19.

[9] Sullivan & Cromwell LLP represented *amicus curiae* the Securities Industry and Financial Markets Association in connection with the appeal discussed.

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