Hedge Fund Law Report
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Arbitration

Federal District Court Enjoins a Hedge Fund and Its Manager from Pursuing FINRA Arbitration Claims against a Broker-Dealer Because They Were Not "Customers" of the Broker-Dealer

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On May 17, 2013, the United States District Court for the Southern District of New York (Court) enjoined a hedge fund and its manager (defendants) from continuing to pursue a Financial Industry Regulatory Authority, Inc (FINRA) arbitration against a bank and its affiliated broker-dealer (plaintiffs). For detailed coverage of the plaintiffs' complaint in this matter, see "Recent Lawsuit Addresses the Question of When a Hedge Fund Manager Is a Customer of a Broker-Dealer for FINRA Arbitration Purposes," Hedge Fund Law Report, Vol. 6, No. 8 (Feb. 21, 2013). FINRA Rule 12200 requires FINRA members to arbitrate disputes, in the absence of a written agreement, if requested by "customers." The Court determined that the defendants were not "customers" of the broker-dealer affiliate, and therefore arbitration was not required. The decision is likely to curtail the availability of arbitration to hedge funds and their managers seeking to assert claims against certain underwriters of securities. This article summarizes the factual background of the case and the Court's analysis. See also "How Hedge Fund Managers Can Use Arbitration Provisions to Prevent Investor Class Action Lawsuits," Hedge Fund Law Report, Vol. 5, No. 26 (Jun. 28, 2012).

Factual Background

Plaintiffs in this case were SunTrust Banks, Inc. (SunTrust Banks), a financial services company, and SunTrust Robinson Humphrey, Inc. f/k/a/ SunTrust Capital Markets, Inc. (STRH), a broker-dealer affiliated with SunTrust Banks. The defendants were Turnberry Capital Management LP, a feeder fund, and Turnberry Master, Ltd., the master fund for the feeder fund (collectively, Turnberry).

The defendants invested in residential mortgage-backed securities (trust certificates) issued by SunTrust Acquisition Closed-End Seconds Trust, Series 2007-1 (Trust). The trust certificates were originally issued on May 15, 2007 with STRH as co-lead underwriter. However, some of the certificates were not sold at the initial offering, and instead were then made available through Raymond James & Associates (Raymond James), allegedly "a broker with which Turnberry had a longstanding relationship."

Raymond James provided data and advice to Turnberry to help it decide whether to purchase certificates in the Trust. Turnberry contended:

> Raymond James personnel transmitted, among other things, various SunTrust material regarding the investment, including but not limited to the May remittance report for the trust, the SunTrust termsheet and preliminary prospectus, and summary materials describing the underlying mortgage loans. There were also oral communications between Raymond James representatives and [an executive of Turnberry] regarding the nature of the proposed investment.

Turnberry alleged that it relied on SunTrust's (and Raymond James') written representations regarding the nature and quality of the underlying mortgage loans, many of which "proved to be materially false and misleading."

Turnberry signed a nondisclosure agreement (NDA) with SunTrust in the second week of June 2007 in order to obtain a copy of the Trust's Pooling and Servicing Agreement (PSA). For discussion of pooling and servicing agreements, see "For Hedge Funds, Ownership of Commercial Mortgage-Backed Securities Servicers Offers a Growing, Uncorrelated Stream of Fee Income and Advantageous Access to Distressed Mortgages, But Not Without Legal and Business Risk," Hedge Fund Law Report, Vol. 2, No. 38 (Sep. 24, 2009). Language in the NDA indicated that it was drafted in anticipation of a sale of certificates by SunTrust to Turnberry. Significantly, however, "the NDA does not itself effect a sale of securities" and contained "language suggesting that the content of the PSA was not being provided as investment advice."

On June 20, 2007, Raymond James purchased two Trust certificates (one in the M-2 tranche and one in the M-4 tranche), worth over $16 million, from SunTrust. The same day, Raymond James then sold these certificates to Turnberry, receiving as a fee the spread between the price paid for the certificates by Raymond James and the price paid by Turnberry. According to Turnberry, "the certificates were earmarked by SunTrust and Raymond James for sale to Turnberry" and "if Raymond James incurred any risk of loss for the securities, it was fleeting at most." SunTrust noted that the records revealed "no reference to [Turnberry] as a current or former brokerage customer of STRH, no brokerage or other customer agreement entered into between STRH and [Turnberry] or that STRH has ever provided any goods, services or advice to [Turnberry] for compensation."

After purchasing the Trust certificates, as losses mounted on its investment in the Trust, Turnberry e-mailed SunTrust requesting access to the mortgage loan files underlying the Trust. SunTrust informed Turnberry that it was no longer the owner of the mortgage loans and could not direct the Trust's servicer or interim seller to release the loan files.

On November 28, 2012, the defendants filed an arbitration claim against STRH, SunTrust Capital Markets, Inc., SunTrust Banks and Raymond James. The defendants alleged violations of FINRA rules and state law related to losses they suffered from their investment in the Trust.

Legal Standard

FINRA Rule 12200 requires parties to arbitrate before FINRA if:

- Arbitration under the [FINRA] 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 an 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.

The Second Circuit has held that the terms of the FINRA Code "should be construed in a manner consistent with the 'reasonable expectations' of FINRA members." Consistent with the federal policy favoring arbitration, "any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration."

The parties agreed that STRH is a FINRA member and that the dispute arose in connection with its business activities, and, additionally, that STRH and Turnberry did not agree in writing to arbitrate. Thus, the sole question before the Court was whether the defendants could compel arbitration based on their allegation that Turnberry was STRH's "customer" for the purposes of FINRA Rule 12200.

Applicable Law on the Definition of "Customer"

The FINRA code defines a "customer" simply by stating, "[a] customer shall not include a broker or dealer." Courts have ruled, however, that "customer" must have a narrower definition than "all entities other than brokers or dealers." The Second Circuit has held that "[t]he term 'customer' includes at least a non-broker or non-dealer who purchases, or undertakes to purchase, a good or service from a FINRA member."

The Second Circuit clarified the scope of "customer" in two recent cases. In *UBS Financial Services, Inc. v. West Virginia University Hospitals, Inc.*, the Second Circuit found that the defendant, which issued bonds structured as auction-rate securities at the plaintiff's recommendation, was the plaintiff's customer. In determining that the defendant was a "customer," the Second Circuit noted that plaintiff advised the defendant on the appropriate bond-issue structure; facilitated the auctions at which the bonds' interest rates were set; and performed various other functions as the defendant's adviser. The Second Circuit reached the opposite conclusion in *Wachovia Bank, National Association v. VCG Special Opportunities Master Fund, Ltd.* In that case, the plaintiff and the defendant had entered into a credit default swap in which each party acknowledged that the other party acted only at arm's length; was not the other's agent, broker, advisor or fiduciary in any respect; and they would not be relying on any advice or evaluation from the other party. See "Second Circuit Rules Hedge Fund VCG Is Not Entitled to Arbitration in CDS Litigation Because It Was Not a Customer of Wachovia Bank," Hedge Fund Law Report, Vol. 5, No. 5 (Feb. 2, 2012).

SunTrust Did Not Prepare Goods or Services That Indicated a Customer Relationship

The Court examined each ofthe four arguments that Turnberry advanced in support of its assertion that it was SunTrust's customer.

Documents Prepared by SunTrust and Provided by Raymond James

Turnberry alleged that it relied on documents provided to it by Raymond James and prepared by SunTrust. The Court found that "the mere fact that Turnberry consulted materials prepared by SunTrust does not entail that Turnberry received investment advice from SunTrust, nor does it evidence any other direct relationship sufficient to make Turnberry SunTrust's customer." Turnberry did not receive any services from SunTrust and did not pay SunTrust any fees. Instead, Raymond Jameswas the entity that provided investment services to Turnberry. Turnberry's allegation – that it was "reasonably forseeable" that the investment-related documents SunTrust supplied to Raymond James would induce Turnberry to invest – was not sufficient to turn Turnberry into SunTrust's customer.

Nondisclosure Agreement and Pooling and Services Agreement

The Court found that the NDA was not sufficient to create a customer relationship – while it contemplated the sale of securities by SunTrust, it did not effect such a sale and expressly exempted SunTrust from liability related to the proprietary information in the NDA. The PSA's terms likewise indicated that it had not been provided as financial advice from SunTrust to Turnberry and therefore could not have formed the basis of a customer relationship.

"Economic Reality" of Raymond James' Role

Turnberry urged the Court to ignore Raymond James' brokerage role because "the economic reality is that [Raymond James] was merely a conduit" and engaged in "riskless trading" in a transaction in which the real parties were SunTrust and Turnberry. First, the Court questioned the viability of the "economic reality" argument, finding that the one case which Turnberry cited in support (*Lehman Brothers, Inc. v. Certified Reporting Co.*) was not controlling and was distinguishable, for reasons that included the fact that "the Lehman plaintiff's involvement in the defendants' investment decision was deeper than simply providing background materials." Second, in the *Lehman* case, the Court explicitly relied on policy considerations including (1) "the federal mandate to resolve all doubts in favor of arbitration" and (2) the need to uphold commercial integrity in cases where plaintiffs solicit investors using allegedly bad market information and arbitration is the only available remedy. The Court found no such solicitation present here – Turnberry was not solicited and advised by SunTrust, but rather by Raymond James, and Turnberry maintained the remedy of suing SunTrust through normal litigation. Finally, even accepting the availability of the "economic reality" argument, the "economic reality" was that SunTrust "did not consistently seek to shield itself from liability by using brokers, but rather turned to brokers to sell certificates that it was not able to sell itself."

The Court observed that its conclusion that Turnberry was not SunTrust's customer was supported by decisions in other federal district courts holding that where an investor buys securities from a broker rather than directly from the underwriter or issuer of the security, the investor is not a customer of the underwriter or issuer.

Post-Transaction Communications between SunTrust and Turnberry

Turnberry argued that e-mails between Turnberry and SunTrust personnel exchanged after the transaction evidenced a customer relationship. The Court disagreed, noting that Turnberry asked SunTrust for help because SunTrust was familiar with the underlying mortgage loans. Nothing in the post-transaction e-mails suggested that Turnberry was SunTrust's customer, and that in fact, "SunTrust repeatedly referred Turnberry to third parties rather than helping Turnberry itself."

Injunction

Concluding that Turnberry was not SunTrust's customer, the Court permanently enjoined the defendants from pursuing FINRA arbitration against the plaintiffs.

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