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The Professional Lines ALERT

Broker Associated With Defunct Firm May Compel FINRA Arbitration

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In a case of first impression, a California Court of Appeal ruled that the withdrawal of a brokerage firm's Financial Industry Regulatory Authority (FINRA) registration does not impair the rights of individual registered representatives from compelling FINRA arbitration.

Defendant and his investment firm (the Firm), opened an investment account for Plaintiff (the Partnership) with a securities broker (the Broker). Defendant maintained various FINRA registrations with the Broker.

The Partnership account agreement contained an arbitration clause applicable to any controversy arising out of the Partnership's accounts, the agreement or breach of the agreement. The arbitration clause required that claims against the Broker, its officers, directors, agents, registered representatives and/or employees had to be arbitrated pursuant to the rules then in effect of the National Association of Securities Dealers, Inc. (NASD), now FINRA.

On the advice of Defendant, the Partnership invested more than $4 million in several tenancy-in-common investments offered by the Broker. The investments failed. The Partnership brought investment suitability claims against Defendant, the Firm, the Broker and 13 other entities that participated in the investments. The Broker went out of business and its FINRA membership lapsed.

Defendant petitioned to compel arbitration before FINRA under the arbitration clause. The trial court denied the petition based on FINRA Code of Arbitration Procedure Rule 12202. Rule 12202 precludes arbitration of claims by or against a member without a customer's written consent if the firm's membership is terminated, suspended, cancelled, or revoked, if the member has been expelled from FINRA, or if the member is defunct. The trial court concluded that under Rule 12202, Defendant's right to arbitrate was dependent on the Broker's rights under the Rule. Because the Broker was defunct, Defendant had no such right.

On appeal, the court found that Defendant and the Firm were not parties to the account agreement and could not enforce the arbitration clause on that basis. However, because the account agreement expressly required arbitration of claims against the Broker's agents and registered representatives, Defendant and the Firm could enforce the agreement as third-party beneficiaries of the contract.

The Partnership argued that, because the Defendant's and the Firm's right to compel arbitration was derived from the Broker's FINRA registration, the individual associated persons should have no greater

rights once the registration lapses. However, the court found that, absent express language that the individual broker had no right to compel, it would not read an implied termination provision into the rule. The court also found support in FINRA Rule 12200, which establishes mandatory arbitration of disputes on claims between a customer and members and associated persons. The court reasoned that if FINRA intended to include associated persons within the scope of Rule 12202, it would have expressly done so as in Rule 12200.

The court concluded that members and registered representatives have independent rights to compel arbitration of disputes with customers. When a member loses its FINRA membership, only the member, and not the individual broker, loses the right to compel arbitration.

Comment Re Potential New Rules Under Dodd Frank

In the wake of the financial failure of brokerage firms there has been substantial litigation over this issue. However, the law may change yet again in the near future.

Thus, many of the firms that sold tenancy-in-common investments have failed, leaving individual brokers to fend for themselves.

Under Rule 166.5, the U.S. Commodity Futures Trading Commission already mandates that commodities brokers provide written arbitration opt-out disclosures to customers in their account agreements. SEC Commissioner Luis Aguilar recently called for the Commission to follow suit based on provisions of the Dodd Frank law allowing the SEC to prohibit or curtail compulsory arbitration provisions. Investor advocates have been vocal in seeking these reforms in light of FINRA decisions such as a ruling in February of this year. There, a panel held that the Federal Arbitration Act trumps FINRA rules such that Charles Schwab & Co. had the right to both compel arbitration and prohibit class action claims by customers under its compulsory dispute resolution provisions.

Ronay Family Limited Partnership v. Robert R. Tweed (Cal.App. 4 Dist., May 23, 2013)
