Credit Default Swaps and “Customers” under FINRA Rules

Wachovia Bank, National Ass’n v. VCG Special Opportunities Master

The FINRA Code of Arbitration Procedure for Customer Disputes provides for mandatory arbitration of disputes between a FINRA member and its “customers.” FINRA Rule 12200. FINRA defines a customer as a person or entity (not acting in the capacity of an associated person or member) who transacts business with any member firm or associated person. An issue often arises when a member of FINRA facilitates a transaction between two parties; one party may try to force arbitration claiming that they were a “customer” of the FINRA member. In Wachovia Bank, National Ass’n v. VCG Special Opportunities Master Fund, Ltd., No. 10-1648-cv, 2011 WL 5110122 (2d Cir. Oct. 28, 2011), the Second Circuit addressed whether a third party is a customer of a FINRA member who facilitates a credit default swap.

A credit default swap is the most common form of a derivative. A CDS is a contract which transfers credit risk from a protection buyer to a credit protection seller. The buyer makes a series of payments to the seller in exchange for the seller’s agreement to make payments to the buyer upon the happening of certain events, most often the default of a loan. For this reason, a CDS is often an effective way to manage the risk of default that accompanies from holding debt.

The International Swaps and Derivatives Association has standard forms to document CDS agreements.

In Wachovia, VCG, a hedge fund, contacted an employee of Wachovia Capital Markets, a member of FINRA, to initiate negotiations for a credit default swap agreement between VCG and Wachovia Bank, which is not a member of FINRA. VCG then entered into an CDS agreement with Wachovia that required
Wachovia to pay a fixed, periodic fee to VCG in exchange for VCG’s agreement to make payments to Wachovia if a company defaulted on a collateralized debt obligation.

Eventually, the parties disputed the extent of VCG’s obligation under the CDS agreement, and VCG sued Wachovia in state court and initiated arbitration proceedings against WCM. Wachovia and WCM moved to enjoin the arbitration, arguing that VCG was not a customer of WCM within the meaning of the FINRA Code. The district court denied the motion.

On appeal, the Second Circuit reversed and concluded that VCG was not a customer of WCM for two reasons: (1) WCM provided only pricing information; and (2) the contract between WCM and VCG explicitly stated that WCM wasn’t acting as a broker.

The Second Circuit recognized that summary judgment would not be appropriate, however, if there was a genuine dispute about the role played by the FINRA member in connection with a credit default swap. The court contrasted *Citigroup Global Markets, Inc. v. VCG Special Opportunities Master Fund Ltd.*, 598 F.3d 30 (2d Cir. 2010). In that case, VCG entered into a CDS agreement with Citibank upon the recommendation by Citigroup Global Markets, Inc., a Citibank affiliate. VCG claimed it had a brokerage services agreement with CGMI and received and that it relied upon CGMI’s advice. There, the Second Circuit granted a preliminary injunction against VCG’s attempt to proceed with arbitration because the record raised factual questions whether VCG was in fact a customer.

The court also contrasted a case the court decided a month earlier: *UBS Financial Services Inc. v. West Virginia Hospitals, Inc.*, No. 11-0235, 2011 WL 4389991 (2d Cir. Sept. 22, 2011). In *UBS*, the Second Circuit held that the undisputed facts showed that the party attempted to proceed with a FINRA arbitration was a customer of the FINRA member. There, West Virginia Hospitals structured bond offerings as auction rate securities in accordance with UBS’s advice and agreed to pay UBS a fee for its services in facilitating the auctions for the bonds. In Second Circuit concluded that as a matter of law, the hospitals were UBS’s customer.
But here, the court continued, there was no evidence of a customer relationship. The court reasoned that there was not even a claim that VCG had a brokerage agreement with WCM, and in addition, the relevant agreements expressly disclaimed any sort of advisory, brokerage, or other fiduciary relationship.

The Second Circuit’s decision is available here.