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ARBITRATING THE BARELY LEGAL

Thoughts on the Private Application of Rule 2010

By
Aegis Frumento and Stephanie Korenman*

I. In the Beginning: Better than Barely Legal

The next time you walk past Bowling Green in lower Manhattan, look across the street at No. 2 Broadway. Today you'll see a massively boring steel and glass building, but on November 16, 1892, you would have seen a 14-story arcaded red brick fortress sprouting a lookout tower. Designed by George B. Post, this Romanesque building, "as noble as anything in Florence . . . [and] . . . the most impressive exchange structure ever seen in Manhattan," [1] was the New York Produce Exchange.

We start there because Produce Exchange member Edwin Johnson had that day sold 1,000 barrels of cottonseed oil to Whitman & Co., whose principals were also members. Whitman & Co. was to take delivery by its own tank cars at the mills in Sulphur Springs and Wolfe City, Texas. But when Whitman & Co. went to send the tank cars in December, the mills told it not to bother because they had already delivered the oil to someone else. Meanwhile, the price had increased, causing Whitman & Co. an $8,000 loss.

Anticipating *The Producers* by almost a century, Johnson had apparently sold the oil twice, taking personal advantage of the price increase. Whitman & Co. complained to the Produce Exchange's complaint committee, which held a hearing and suspended Johnson's membership. Johnson sued the Exchange to get his seat back—and lost. Johnson breached his contract and then tried to avoid personal liability by claiming he was just acting as broker for the mills. Whitman & Co. had charged, and the Exchange's complaint committee had found, that Johnson had violated the Exchange's by-laws by engaging in "proceedings inconsistent with just and equitable principles of trade."[2] It was, so far as we can tell, the very first time that phrase appeared in a reported decision of New York's highest court.[3]

To be clear—and this is critical to what follows—all the courts that heard Johnson's case agreed that he had simply failed to perform a contract and raised lawful defenses to personal liability. And all agreed that there was nothing "illegal" about any of that. The intermediate appellate court actually ruled in Johnson's favor, opining that "a breach of contract in and of itself is not inconsistent with just and equitable principles of trade in a true sense."[4] But the Court of Appeals went further in reversing on appeal. "It is manifest that a contract valid in form and enforceable by action [at law] may nevertheless have been induced by unfair dealing and that its performance may be evaded upon unjust or frivolous pretenses."[5]

> [T]he [Produce Exchange] by-law extends to conduct in respect to a contract, either in

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> its inception or execution, or the failure to execute it, which is inconsistent with just and fair dealing, although it is not of that specific and definite character of which the law in an action between the parties will take notice. The law does not undertake to enforce mere moral obligations. Their observance, however, by parties to contracts is required by the principles of commercial honor and integrity. . . .[6]

That being so, the Produce Exchange was entitled to find that Johnson's conduct violated its by-law provision forbidding any "proceedings inconsistent with just and equitable principles of trade." Johnson's expulsion stuck, and with it the concept of a moral duty of fair dealing, enforceable by an exchange against its members, that extends beyond the barely legal.

The Produce Exchange's by-laws had required its members to abide by just and equitable principles of trade since 1864. Similar provisions became common in the governing documents of commercial exchanges across the country.[7] However, as of 1865, neither the New York Stock Exchange nor any of the lesser stock exchanges then in existence imposed a similar obligation.[8] But finance soon surpassed commerce. In 1903, George B. Post favored Athens over Florence in designing the fake temple that is still home to the New York Stock Exchange. By 1909, Section 6 of Article 17 of the Constitution of the Exchange provided for the suspension or expulsion of any member found "guilty" of "any conduct or proceeding inconsistent with just and equitable principles of trade."[9] That felicitous phrase, combined with another from the Court of Appeals' *Johnson* opinion, worked its way up the constitutional hierarchy. Soon, Article I of the New York Stock Exchange Constitution set forth as two of its governing principles "to maintain high standards of commercial honor and integrity among its members, and to promote and inculcate just and equitable principles of trade and business." Noble words, indeed. But they didn't prevent the Crash of 1929.

One reason is that from their very coinage, those standards and principles were only intended to prevent members from trying to cheat other members. Johnson was suspended for unfair conduct against a fellow Produce Exchange member. The New York Stock Exchange suspended members who cut into fellow members' business by dealing with rival exchanges.[10] Even the Buttonwood Agreement of 1792—the traditional start of the New York Stock Exchange—was just a price-fixing compact, one simple paragraph by which its members promised each other not to charge less than ¼% commission on stock sales.[11] Protecting the investing public had nothing to do with any of these.[12]

That attitude changed with the federal securities laws enacted in the wake of the 1929 Crash. The Securities Exchange Act of 1934 required that stock exchanges have rules "designed . . . to promote just and equitable principles

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of trade . . . and, *in general, to protect investors and the public interest.*"[13] The 1938 Maloney Act extended the same to national associations created to regulate over-the-counter securities dealers.[14] Both the House and Senate Reports on the Maloney Act identified the "problem of regulation" as "First, to protect the investor and the honest dealer alike from dishonest and unfair practices by the submarginal element in the industry; [and] second, to cope with those methods of doing business which, *while technically outside the area of definite illegality, are nevertheless unfair both to customer and to decent competitor. . . .*"[15] This was of a piece with all the securities regulations passed in the 1930s and 40s.[16] So, what began as a check on members legally cheating each other became a principle to prevent members from legally cheating the public.

II. FINRA Rule 2010

Back to the present. The one and only association ever formed under the Maloney Act—the National Association of Securities Dealers, Inc. ("NASD")—is now the Financial Industry Regulatory Authority ("FINRA"). FINRA enforces all rules governing securities firms. And FINRA Rule 2010 (like its predecessor NASD Conduct Rule 2110) says *in toto:* "A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."

Those standards and principles today govern member-customer relations as much as or even more than intra-member conduct. And yet, a good deal of injury is still visited on securities industry customers, employees and competitors by actions that do not exactly fit the molds of "fraud," "negligence," "breach of fiduciary duty," or "breach of contract"—but still are unfair. Despite Rule 2010 and its predecessors, regulated parties too often get away with conduct "outside the area of definite illegality [but] nevertheless unfair"—just what the *Johnson* court described and the Exchange Act and the Maloney Act targeted.

Enforcing Rule 2010 today falls upon FINRA's Enforcement Department. However, FINRA Enforcement will never have the resources needed to investigate and adjudicate more than the smallest fraction of the most visible and egregious examples of dishonorable, unjust and inequitable conduct. And in any event, the regulators don't have a great track record as cops on that beat. Under the NASD's and FINRA's enforcement jurisdiction, Rules 2110 and 2010 didn't prevent the crash of 1987, the tech bubble of 1998-2000, the MBS crash of 2007-2009—or Bernie Madoff's massive Ponzi scheme—any better than the New York Stock Exchange's Constitution prevented the Crash of '29. In 1996, the SEC even sanctioned the NASD for colluding to permit its large market-maker members to rig the dealer markets, very much like a corrupt police department in a gangster movie.[17] Instead, FINRA Enforcement has all too often used Rule 2010 to punish hapless registered representatives for misbehavior that is barely even connected to the securities industry.[18]

If we seriously want securities firms and professionals to practice "commercial honor" and "just and equitable principles" in their dealings with the public, then we should adopt a different tack towards Rule 2010. The only other parties with the incentive to expose and seek redress for Rule 2010 violations are the victims of dishonorable, unjust and inequitable—but still legal—conduct. Victims of such unethical but barely legal conduct, and arbitrators hearing their cases, should take matters into their own hands.

III. Dishonorable Conduct in Arbitration

We know that suggesting that victims be able to enforce Rule 2010 will raise an obvious objection: It has long been held that there are no private rights of action under FINRA (or old NASD or NYSE) rules.[19] Also, as the *Johnson* court recognized over a century ago, courts do not enforce mere moral obligations, which is what Rule 2010 largely prescribes. We have no quarrel with that result. The courts have enough to do enforcing the laws of the legislatures without also having to deal with FINRA's. But it is a mistake born of overly legalistic thinking to believe that lacking a private right of action matters all that much.

That is because no private party can bring a claim based on a violation of a FINRA Rule—*in a court of law*. But how many securities cases involving FINRA members are heard in law courts these days? None. Instead, they are heard in FINRA arbitration rooms, and this gets us to our main point. That parties could not bring Rule 2010 claims in a court says nothing at all about what can be presented to, argued before, and decided by an arbitration panel. An arbitration is not a court case. Arbitrators are not strictly bound by the substantive law. They are not bound by the rules of evidence. They can hear any testimony and consider any argument. They have wide latitude in rendering awards. Yet, most arbitrators would deny thinking of "commercial honor" or "just and equitable principles of trade" as elements of an award. And advocates generally do not seek remedies based directly on conduct that is legal but unethical. The "no private right of action" thing scares them both. It shouldn't.

Arbitrators know when FINRA members before them have violated "high stan-dards of commercial honor and just and equitable principles of trade"—they know it sooner and more surely than FINRA's Enforcement Department ever would. Parties should not fear asserting a breach of those principles against FINRA members. We all know that arbitrators decide on the basis of fairness and equity more often than on any substantive law. *That is what it means not to strictly follow the law.* And arbitration awards, as a practical matter, cannot be vacated if there is a "barely colorable justification" for them.[20] That a FINRA member acted dishonorably, unjustly or inequitably provides far more than a "barely colorable justification."

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Firms can act dishonorably, unjustly and inequitably in ways limited only by the imagination, and beyond our ability to catalog. Rather, we look here at but one genre of dishonorable conduct, that of FINRA firms legally "gaming" the arbitration process to disadvantage adversaries by making them fight on two fronts. Two recent examples illustrate what we mean.

IV. Gaming the System 1: EFL Note Cases

Our first example involves employees. Brokerage firms often lure brokers away from competing firms with the so-called "employee forgivable loan" ("EFL"). A broker would be recruited with the promise of a large sum of money paid on arrival. The firm would structure the advance as a loan evidenced by a promissory note to be repaid out of guaranteed bonuses, or forgiven, over the subsequent term of the broker's employment. However, if the broker were to leave the firm, for whatever reason (even termination without cause), he or she would need to repay the balance due.

Under FINRA rules, firms must arbitrate disputes between firms and with their brokers.[21] A firm's attempt to recover the balance of an EFL would clearly be such a dispute. But savvy brokers faced with the prospect of having to repay very large EFLs (and any broker given such a large advance would be nothing if not savvy) could bring counterclaims. Ex-brokers will often have legitimate claims that the firm recruited them under false pretenses, or sabotaged their ability to service or attract customers after they were hired, or tried to take their book by sullying their reputations after they left. Brokers facing the wrong end of a promissory note case could both delay repayment and have a fighting chance of paying less—on occasion nothing at all—by asserting such counterclaims.[22]

However, in New York there is an accelerated procedure for promissory notes that could result in a judgment in only a few months.[23] And so, firms began having affiliates that were *not* FINRA members make EFLs to recruited brokers, under notes only enforceable in New York state courts. The firm's non-FINRA affiliate could file a motion for summary judgment in lieu of complaint under New York's accelerated procedure and get a judgment against an ex-broker many months before an arbitration panel could hear and decide the broker's counterclaim against the firm.

The existence of the judgment would become a disclosable event on the broker's record, hindering his or her ability to obtain a position at other major firms. A broker with money would be coerced into paying off the note just to avoid a blot on his or her record, regardless what counterclaims he or she might have. The broker's arbitration would proceed in due course, but the broker would by then, in many cases, be too broke to see it through. And, in all events, it is always easier for an arbitration panel to award a firm a reduced amount on an EFL note than it is to require a firm to pay money to a broker.

Merrill Lynch used just that strategy when it had a non-FINRA affiliate "lend" $2.8 billion to about 5,000 brokers to induce them to stay after Bank of America acquired it in the wake of the 2008 market collapse. Then, during the course of 2009, that non-FINRA affiliate brought over 90 actions in New York state court to recover on EFL promissory notes.

This clever strategy was perfectly legal, but it was not honorable. It was a way to circumvent Merrill's obligation to arbitrate employment disputes and to curtail brokers' rights to file counterclaims. It made it more expensive, time-consuming and generally cumbersome for brokers to assert their rights. A fair observer—a fair arbitrator—would think it was a violation of FINRA Rule 2010. And in January 2012, Merrill Lynch settled FINRA Enforcement charges that it had indeed violated Rule 2010 by using a non-FINRA affiliate to enforce EFLs in New York state court, paying a $1,000,000 fine for the violation.[24]

V. Gaming the System 2: Two-Hatted Brokers

Our second example involves customers whose broker wears two hats—as registered representative of a broker-dealer and as adviser representative of that broker-dealer's affiliated registered investment adviser ("RIA"). The broker-dealer is a FINRA member; the RIA is not, and therefore not obligated to arbitrate before FINRA. The customer has relationships with both. Must the customer raise claims in two separate forums against the two related entities?

Consider the results of two recent arbitrations. They are uniquely instructive because they are substantially identical. Both involve customer claims against the same firm, FINRA-member Allegis Investment Services, LLC. Both involved the same dually-registered broker/adviser. In both, the RIA affiliate did not appear—in one because it was not named, in the second because it refused to file a submission agreement. Given the nature of arbitration awards, not all the facts are available. The substantive claims are not our concern in any event. But enough was reported for us to get the gist of the two cases for our limited purpose.

In the first case ("*Hansen*"), the Panel dismissed the claims because it found "that FINRA lacks jurisdiction of this dispute . . . because Claimants were not Customers of" the FINRA-member broker-dealer, and that the named advisers "were not acting in their capacity as associated persons of a member." The Panel expressly stated that it reached no conclusions on the merits, even though it held eight hearing sessions at which it heard "the presentation of evidence by both sides."[25]

Less than three months later, a different Panel reached another result. In the second case ("*Watson*"), the affiliated RIA, Allegis Investment Advisors, LLC, *was* named, but it did not file a submission agreement. "However, the Panel found that as Allegis Advisors answered the Statement of Claim, it is bound by

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the determination of the Panel on all issues submitted. The Panel found that the business activities and identities of Allegis Advisors and Allegis Services were conflated with respect to Claimant such that the Panel's determinations apply to Allegis Advisors as well as to Allegis Services."[26] That Panel rendered a joint and several award for the claimant after hearing evidence through nine hearing sessions.

Hansen, *Watson*, and other cases like them are very similar to the EFL note cases. Like in the EFL note cases, it is perfectly legal for RIA affiliates not to submit to FINRA arbitration. And, as in the EFL cases, it is not honorable, just or equitable for a broker-dealer to play a shell game with its customers to force a customer to guess whether it should sue the broker-dealer, the affiliated RIA, or both in different forums. As it is a Rule 2010 violation for broker-dealers to use a non-member affiliate to impede resolving a dispute with an employee, it is a Rule 2010 violation for broker-dealers to use non-member affiliated RIA to hinder a customer seeking redress.[27]

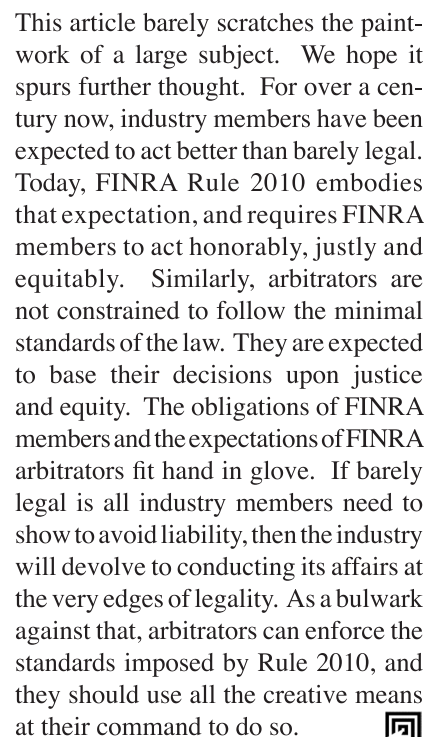
It is clear to us that the *Watson* Panel got it more right than the *Hansen* Panel. But even the *Watson* Panel struggled with the rationale. It is not at all clear how the RIA could "be bound" by the award without submitting an arbitration agreement, merely because an answer was filed on behalf of "Respondents." Better is the notion that the broker-dealer and the RIA's activities were "conflated," but even that is an imperfect reason for holding a non-FINRA-member responsible. If there is any prerequisite to the enforceability of an arbitration award, it is the existence of an arbitration agreement—and there just doesn't seem to be one here.

There is a better way to deal with situations like this, and it turns on arbitrators making practical use of Rule 2010, or at least the principles that motivate it. It would, of course, be best for FINRA itself to tell firms that they cannot evade customer claims by hiding behind affiliated RIAs. This will become more important as more brokers become dually registered, as investment advisers become a large proportion of the wealth management industry. But absent FINRA guidance, we think that the key relevant fact for arbitrators to consider is this: Whether a broker-dealer can adjust a loss on a customer claim internally as between itself and its affiliated RIA. In almost all cases—and we cannot think of an exception—the answer will be: Of course it can! That is the essence of what it means to be "affiliated." If a broker-dealer and its affiliates can adjust losses amongst themselves, then there is only one reason to burden a customer with trying to unravel a multi-faceted relationship or with bringing multiple claims in different forums. That reason is to impair the customer's ability to bring a claim, and that is, however legal it may be, dishonorable, unjust and inequitable—a Rule 2010 violation if ever there was one!

VI. Conclusion: Taking Rule 2010 Seriously

Arbitration panels should not have to contort themselves like the *Watson* Panel did to find liability against non-FINRA member RIAs. There is no reason for it, and a simple solution to it. A customer with related broker-dealer and RIA relationships is already a customer of the FINRA member. If that FINRA member firm tries to avoid liability by claiming that only its own affiliated RIA is responsible, it violates Rule 2010, period. Whether an arbitration panel says so expressly or not, it should enforce the ethical rule by simply estopping the FINRA member firm from making the argument. Of course, a panel need not be fancy in how it does this. It can "estop" the unethical argument merely by denying, without explanation, the broker-dealer's motion to dismiss the claim as against it. By whatever procedure, an arbitration panel has the power to render clean awards against FINRA members without worrying about the jurisdictional niceties of their affiliated RIAs. Panels should craft similar remedies in all cases where a member firm has acted, in any way, dishonorably, unjustly or inequitably against the mandate of Rule 2010.

This article barely scratches the paintwork of a large subject. We hope it spurs further thought. For over a century now, industry members have been expected to act better than barely legal. Today, FINRA Rule 2010 embodies that expectation, and requires FINRA members to act honorably, justly and equitably. Similarly, arbitrators are not constrained to follow the minimal standards of the law. They are expected to base their decisions upon justice and equity. The obligations of FINRA members and the expectations of FINRA arbitrators fit hand in glove. If barely legal is all industry members need to show to avoid liability, then the industry will devolve to conducting its affairs at the very edges of legality. As a bulwark against that, arbitrators can enforce the standards imposed by Rule 2010, and they should use all the creative means at their command to do so.



ENDNOTES

1. Christopher Grey, *A Brick Beauty Bites the Dust,* The New York Times (Aug. 24, 2014) at p. RE8.
2. *People ex rel. Johnson v. N.Y. Produce Exch.,* 149 N.Y. 401 (1896).
3. The New York Court of Appeals decided a companion case the very same day citing the same provision to affirm the suspension of another Produce Exchange member. He had failed to honor a contract to deliver 8,000 barrels of Portland cement. *In re Haebler, 149 N.Y. 414 (1896).* An earlier case appears to have arisen from the same provision but was decided without reported opinion. *Hurst v. N.Y. Produce Exch.,* 100 N.Y. 605 (1885).
4. *People ex rel. Johnson v. N.Y. Produce Exch., 8 Misc. 552, 553 (N.Y. Super. Ct. 1894).*
5. 149 N.Y. at 411.
6. *Id.*
7. S. S. Huebner, *American Produce Exchange Markets,* Annals of the Amer. Acad. of Pol. and Soc. Sci., Vol. 38, No. 2 (Sept., 1911), at 2-4, available at http://www.jstor.org/stable/1011632.
8. Henry Hamon, New York Stock Exchange Manual: Containing Its Principles, Rules, and Its Different Modes of Speculation (1865), available at https://play.google.com/store/books/details?id=DddHAAAAIAAJ&rdid=book-DddHAAAAIAAJ&rdot=1.
9. *See Heim v. New York Stock Ex-*

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change, 64 Misc. 529, 530, 118 N.Y.S. 591, 591 (Sup. Ct. Kings County 1909).
10. *Id.*
11. Facsimile copy available at http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1790/1792_0517_NYSEButtonwood.pdf.
12. Indeed, in 1932, the New York Supreme Court even enjoined the New York Stock Exchange from purporting to protect the public by prohibiting one of its members from selling diversified portfolios of shares (what might today be mutual funds):

> In this case the Exchange says in effect, "We want to safeguard the public." The public has not asked them to do so. Indeed, . . . that part of the public which would buy these "portfolios" by such buying would be in effect replying, "We don't want you to safeguard us." The plaintiff insists that neither it nor its customers have selected the Exchange as such guardian.

Pirnie Simons & Co., Inc. v. Whitney, 144 Misc. 812, 827, 259 N.W.S. 193, 208 (Sup. Ct. N.Y. County 1932). But even there, the Exchange didn't really care so much about investors; it sought to prevent one member's nascent mutual fund from diverting business from other members.
13. Now codified at Securities Exchange Act § 6(b)(5) *(emphasis added)*.
14. Now codified at Securities Exchange Act § 15A(b)(6).
15. House Report No. 2307, 75th Cong., 3d Sess. (May 6, 1938) at 4; Senate Report No. 1455, 75th Cong. 3d Sess. (Jan. 5, 1938) at 3 *(emphasis added)*.
16. *See generally,* Joel Seligman, The Transformation of Wall Street (3d ed. 2003) at 183-89.
17. SEC Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market (Aug. 6, 1996), available at https://www.sec.gov/litigation/investreport/nasdaq21a.htm.
18. This is an old problem dating back to FINRA Rule 2010's predecessor, NASD Conduct Rule 2110. *See, e.g.,* Martin P. Unger, *Are There Limits to FINRA Rule 2010?,* New York Law J. (Oct. 8, 2013); Michael E. Greene, *NASD Conduct Rule 2110: How Far Does It Reach?,* BNA Sec. Lit. & Law. Rep., Vol. 37, No. 21 (May 23, 2005).
19. *See, e.g., Jablon v. Dean Witter & Co.,* 614 F.2d 677 (9th Cir. 1980).
20. In the absence of fraud, bias, or the absence of an agreement to arbitrate, the only ground for vacatur is "manifest disregard of the law." However, that basis is limited to "those exceedingly rare instances where some egregious impropriety on the part of the arbitrators is apparent." *Duferco Int'l Steel Trading v. T. Klaveness Shipping A/S,* 333 F.3d 383, 389 (2d Cir. 2003). Indeed, arbitration awards will be enforced "despite a court's disagreement with it on the merits, *if there is a barely colorable justification for the outcome reached." Wallace v. Buttar,* 378 F.3d 182, 190 (2d Cir. 2004)*(emphasis added)*.
21. FINRA Rule 13200(a).
22. Though brokers need be careful they do not themselves violate Rule 2010 by raising frivolous defenses; recall that was one of Edwin Johnson's original sins.
23. N.Y. CPLR 3213.
24. FINRA Letter of Acceptance, Waiver and Consent No. 2009020188101 (accepted by FINRA Jan. 25, 2012). And yet, other firms still tried to enforce EFL promissory notes in New York State courts. Eventually, the New York courts themselves had to rule that brokerage firms could not use New York's accelerated procedure to evade their obligation to arbitrate employment disputes. *BGC Notes LLC v. Gordon, 142 A.D.3d 435, 36 N.Y.S.3d 130 (1st Dep't 2016)].*
25. *Hansen, et al. v. Allegis Investment Services, LLC, et al.,* FINRA Arb. Case No. 17-00135 (Award, Dec. 19, 2017).
26. *Watson v. Allegis Investment Advisors, LLC, et al.,* FINRA Arb. Case No. 16-03643 (Award, Mar. 6, 2018).
27. The only significant difference between the EFL cases and these is that in the former, the firms had the initiative because they could go to court on a faster track than the brokers could muster in arbitration; in customer cases, the customer almost always has the initiative.

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