

**IN THE UNITED STATES DISTRICT COURT  
FOR THE EASTERN DISTRICT OF PENNSYLVANIA**

<b>BASIL INVESTMENT CORPORATION,</b>	:	<b>CIVIL ACTION</b>
	:	
<b>Plaintiff,</b>	:	
	:	
<b>v.</b>	:	
	:	
	:	
<b>HAMPSHIRE FUNDING, INC. and</b>	:	
<b>CHUBB SECURITIES CORPORATION,</b>	:	
	:	
<b>Defendants.</b>	:	<b>NO. 97-1852</b>

**MEMORANDUM**

**Reed, J.**

**February 19, 1998**

Defendants Hampshire Funding, Inc. (“Hampshire”) and Chubb Securities Corporation (“Chubb”) brought this motion to compel arbitration before the National Association of Securities Dealers (“NASD”) and to stay the proceedings (Document No. 11). Because I find that plaintiff Basil Investment Corporation (“Basil”), Chubb, and Hampshire are bound by the arbitration code of the NASD and that this case does not fall within the exception for disputes arising from the insurance business of an insurance company, the motion will be granted.

**I. Background**

Basil is a broker-dealer registered with the Securities and Exchange Commission and licensed as a broker-dealer under applicable state securities laws. Basil has been a member of NASD since September 1968. Chubb, a wholly-owned subsidiary of Chubb Life

Insurance Company of America (“Chubb Life”), has been a member of NASD since 1969. Hampshire is also a wholly-owned subsidiary of Chubb Life. Nine of the officers and directors of Chubb also serve as officers and directors of Hampshire.

On May 25, 1989, Basil and Chubb entered into an introducing broker’s agreement, pursuant to which Basil was to introduce their clients to Chubb to participate in the Hampshire Programs (“the programs”). Chubb acted as a distributor or clearing agent for these programs. The programs worked as follows: Investors purchased the programs through representatives of Chubb or through brokers, such as Basil. An investor not only purchased mutual fund shares but also a life insurance policy offered exclusively by Chubb Life or Chubb Colonial Life Insurance Company. The investor pledged his mutual fund shares to secure loans from the program for the initial premium on the life insurance policy and then for the subsequent premium payments over a period of ten years.

After the agreement was signed, Basil began to introduce clients to Chubb for the programs. In October of 1996, the defendants received notice from a number of Basil clients that they wanted Chubb to liquidate all of their shares in Oppenheimer Funds, which were used as collateral for premium loans for insurance policies issued in connection with their participation in the programs, and to place 50% of the proceeds into the Van Eck Hard Assets Fund and 50% in the G.T. Global Natural Resources Fund Class B (“B shares”). Chubb decided that it was not in the best interest of these Basil clients to purchase the B shares because the Basil clients were eligible to purchase G.T. Global Natural Resources Fund Class A (“A shares”). The alleged advantage to the client in purchasing A shares instead of B shares was that the client could purchase A shares at net asset value without

incurring an initial 4.75% sales charge normally charged on the purchase of A shares, and because the A shares annual service and distribution fees were .50% lower than B shares. (Hardiman Aff. at 2). According to the defendants, the B shares were also subject to a contingent deferred sales charge of up to 5% if the client sold the mutual fund shares within six years.

In addition, the defendants claim that if Basil's orders were carried out, Basil would have received 75% of the gross dealer concession paid on the clients' purchase of the B shares. Thus, the defendants argue, Basil instructed Chubb to process the liquidated proceeds of its clients' Oppenheimer shares into the B shares solely for the purpose of Basil's own financial advantage. Basil counters that it did not know that its clients were eligible to purchase the A shares at net asset value.

In response to the clients' request, Chubb sent a letter to Basil dated November 6, 1996 providing Basil with two options: (1) Basil could send a letter instructing Hampshire to purchase A shares with the proceeds of the Oppenheimer shares, with an exception for any Basil client who sent a letter to the defendants stating that they were aware that they were eligible to purchase the A shares at net asset value, without an initial sales charge, without a contingent deferred sales charge, and with lower annual service and distribution fees than those associated with the B shares and that the client still wished to purchase B shares, and then Chubb would process the transaction into B shares, or (2) Chubb would reinvest any assets originally directed to B shares by reestablishing 50% of the shares back into the original Oppenheimer account until Chubb received further instructions from the client. (Hardiman Aff. at 2).

Basil sent a letter to Chubb dated November 7, 1996 instructing Chubb to invest in A shares the proceeds that were previously slated to be invested in B shares. (Defs. Mem. Ex. F). Basil claims that Chubb refused to complete the initial request even though it had received statements signed by the clients authorizing them to invest in B shares.

In March of 1997, Basil filed a complaint against the defendants claiming disparagement, interference with contractual relations, and breach of contract. The defendants filed this motion to compel NASD arbitration and stay the proceedings on August 21, 1997.

There is no arbitration clause in the agreements between Basil and the defendants regarding the brokerage arrangement for the programs. Both parties agree, however, that the NASD Code of Arbitration Procedure requires members to arbitrate disputes arising out of a member's business. Basil contends, however, that there is an exception to arbitration for disputes involving the insurance business of any member which is also an insurance company. Basil also argues that Hampshire is not a member of NASD nor an "associated person" under the NASD Code of Arbitration and thus there is no arbitration agreement between Basil and Hampshire. The defendants reply that the dispute does not arise from the parties' insurance business and that Hampshire is closely affiliated with Chubb, which renders it a "certain other" person under the NASD Code of Arbitration.

## **II. Applicable Provisions of the Federal Arbitration Act ("FAA")**

The parties do not dispute that if there is an agreement between the parties to arbitrate, the FAA applies. The FAA establishes a broad federal policy in favor of

arbitration of disputes. Thus, “any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration.” Moses H. Cone Memorial Hospital v. Mercury Construction & Development Corp., 460 U.S. 1, 24-25 (1983) (“Unless it may be said with positive assurance that the arbitration clause is not susceptible of an interpretation that covers the asserted dispute, the controversy will not be excluded from coverage of the arbitration clause.”)

This Court must stay the proceedings if the parties have agreed in writing to arbitrate the issues contained in the underlying action. See 9 U.S.C. § 3. Section 3 of the FAA provides that a district court “upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement. . . .” A district court may issue an order “directing that such arbitration proceed in the manner provided in such agreement” upon the petition of a party “aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration.” 9 U.S.C. § 4.

### **III. The NASD Code of Arbitration**

The rules of the NASD constitute a contract between members of the exchange. See Muh v. Newberger Loeb Co., 540 F.2d 970, 973 (9th Cir. 1976). Thus, members of the NASD are contractually obligated to abide by the NASD Manual - Code of Arbitration (1996). (“NASD Code”). See id. at 972; Goldberg v. Donaldson, Lufkin and Jenrette Securities, 650 F. Supp. 222, 225-26 (N.D. Ga. 1986).

Section 10101 of the NASD Code provides:

for the arbitration of any dispute, claim, or controversy arising out of or in connection with the business of any member of the [NASD], . . . with the exception of disputes involving the insurance business of any member which is also an insurance company: (1) between or among members; (2) between or among members and associated persons; (3) between or among members or associated persons and public customers, or others. . . .

In addition, § 10201 of the NASD Code provides that:

[a]ny dispute, claim, or controversy eligible for submission under the Rule 10100 Series between or among members and/or associated persons, and/or certain others, arising in connection with the business of such members(s) or in connection with the activities of such associated person(s), . . . shall be arbitrated under this Code. . . .

#### **IV. Analysis**

Chubb and Basil are both members of the NASD and are thus contractually obligated to abide by the NASD Code. Because this dispute centers on Chubb's decision not to process certain securities transactions for Basil's clients, it arises from Chubb and Basil's business with each other as clearing firm and broker under their brokerage agreement. Thus, Basil and Chubb must arbitrate the claim in this case because the subject is within the scope of the parties' agreement to arbitrate. See Goldberg, 650 F. Supp. at 226.

Hampshire, however, is not a member of the NASD, and Basil points to this as grounds for denying the defendants' motion. Basil argues that Hampshire is not an associated person under the NASD code, citing Tays v. Covenant Life Insurance Co., 964 F.2d 501 (5th Cir. 1992), which held that "associated persons" includes only natural persons and not corporations under the NASD rules. In McMahan Securities Co. v. Forum Capital Markets L.P., 35 F.3d 82 (2d Cir. 1994), the Court of Appeals for the Second Circuit refused

to follow Tays. The McMahan court held that the NASD rules “do not invariably require an ‘associated person’ to be a natural person, at least where the entity in question is a partner of a member.” Id. at 87. The McMahan court further reasoned that a person

who is neither a member nor an associated person is nevertheless appropriately joined in the arbitration where that party plays an active role in the securities industry, is a signatory to a securities-industry arbitration agreement (or is an instrument of another party to the arbitration), and has voluntarily participated in the particular events giving rise to the controversy underlying the arbitration.

Id. at 88.

I have been unable to find and the parties have not cited any case from this circuit with which to guide my determination of whether Hampshire qualifies as either an “associated person” or a “certain other” under the NASD Code. Basil contends that this Court should follow the path of the Tays court. However, Tays is distinguishable: while the court in Tays only confronted the question of whether an associated person under the NASD Code must be a natural person, the defendants argue that Hampshire qualifies as a “certain other,” not an “associated person.”

I find the reasoning of McMahan to be persuasive. Hampshire plays a role in the securities industry, is an instrument of Chubb, and voluntarily participated in the events giving rise to this controversy. Chubb and Hampshire acted jointly in the administration and distribution of programs to investors, they share officers, directors, and office space, and both are wholly-owned subsidiaries of Chubb Life. Thus, Hampshire is a certain other under the NASD Code and is bound to arbitration of this dispute before the NASD with Chubb and Basil.

Addressing Basil's final argument, I find that this case does not fall within the insurance exception provided in § 1 of the NASD Code. First, although the transactions conducted through the programs involved the purchase of life insurance policies, neither Basil, Chubb, or Hampshire are insurance companies. Second, the claims made by Basil arise from Chubb's refusal to clear certain requests made by Basil's clients to trade shares from one fund to another. The transactions in question for which Basil was to act as a broker and for which Chubb was to act as a clearing agent under the agreement among the parties were primarily for the sale of mutual funds. Thus, the disputes do not arise from the insurance business of a member which is also an insurance company. See Trumbetta v. Metropolitan Life Insurance, No. 94-3275, 1994 WL 481152, at \*2 (E.D. Pa. Sep. 1, 1994); Foley v. Presbyterian Ministers' Fund, No. 90-1053, 1992 WL 63269, at \*2 (E.D. Pa. March 19, 1992).

## **V. Conclusion**

Based on the foregoing, I find that the parties are bound by the NASD Code of Arbitration which requires arbitration of this dispute; thus, I will order arbitration of this matter before the NASD pursuant to § 4 of the FAA and stay the trial of this action until such arbitration is completed pursuant to § 3 of the FAA.

An appropriate Order follows.

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<b>Plaintiff,</b>	:	
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<b>HAMPSHIRE FUNDING, INC. and</b>	:	
<b>CHUBB SECURITIES CORPORATION,</b>	:	
	:	
<b>Defendants.</b>	:	<b>NO. 97-1852</b>

**ORDER**

**AND NOW**, this 19th day of February, upon consideration of the motion of defendants Hampshire Funding, Inc. and Chubb Securities Corporation to compel arbitration before the National Association of Securities Dealers (NASD) and to stay the proceedings until the completion of such arbitration (Document No. 11), the response of plaintiff Basil Investment Corporation (Document No. 12), and the reply of the defendants (Document No. 13), it is hereby **ORDERED** that the parties are directed to proceed to arbitration before the NASD in the manner provided by the NASD Code of Arbitration and the trial of this case is **STAYED** until such arbitration has been completed.

**IT IS FURTHER ORDERED** that the clerk shall remove this case from the active docket and transfer it to the Civil Suspense Docket until the completion of all arbitration procedures, any post-arbitration review, and the entry of a final order after completion thereof.

**IT IS FURTHER ORDERED** that the parties shall notify this Court in writing when as and if the arbitration or other procedure results in a settlement or other final disposition so that the Civil Suspense Docket may be purged.

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**LOWELL A. REED, JR., J.**