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SECURITIES AND COMMODITIES
LITIGATION AND ARBITRATION

INVESTOR RIGHTS

STOCKBROKER
MISCONDUCT

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Via e-mail

Elizabeth M. Murphy
Secretary, Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090.

Re: File Number SR-FINRA-2010-035

Dear Ms. Murphy:

I am writing to comment on File Number SR-FINRA-2010-035, in which FINRA proposes to amend its Discovery Guide production lists. FINRA's proposed new Guide has some improvements over the current Guide, including in particular (1) the requirement for respondents to produce commission runs in all cases involving solicited transactions (List 1, Item 20) (but see comment 5 below), (2) the requirement for respondents to produce investigations and charges by regulators regarding associated persons (List 1, Item 16), not merely disciplinary actions, and (3) increased discovery regarding other associated persons besides the associated persons at issue (see comment 27 below). The negative aspects of the new Guide, however, outweigh the improvements.

I dislike the current Discovery Guide, but my present practice is not to object to the Guide's requirements. I anticipate, however, that, if the new Guide is adopted without change, I will file objections to Discovery Guide production in every case. Many of my opponents already file these objections. The result will be increased time and effort to resolve discovery issues, while the parties dually litigate both Discovery Guide production and their own discovery requests. This result would be opposite to the new Guide's intended effect. If the Commission believes that a Discovery Guide should continue to be used, but the Commission is not inclined to make substantial changes to the new Guide, the Commission should reject the new Guide in toto, leaving the current Guide in place. As it is presently constituted, the new Guide is materially worse than the current Guide.

The following are my specific comments regarding the new Guide:

1. When supervision is an issue, the current Guide (List 5, Item 2) requires production of all documents reflecting supervision of the associated person and the customer accounts at issue. The new Guide removes this requirement and instead requires production only of supervisory documents relating to the claimants (List 1, Items 7(a) and 13(a)), supervisory review of correspondence with the claimants (List 1, Item 7(b)), compliance department communications with associated persons relating to the securities or claimants at issue (List 1, Item 9), exception reports (List 1, Item 13(b)), and internal audits at the branch (List 1, Item 14).

This narrow and limited production of documents relating to supervision is inadequate when supervision is at issue, particularly in comparison to the current provision which requires production of all documents reflecting supervision of the associated person. For example, the new Guide does not require production of the following documents which are presently required: documents reflecting compliance meetings between associated persons and their immediate supervisors, documents reflecting supervisory review of incoming or outgoing correspondence relating to the security at issue, documents reflecting supervisory evaluations of the associated persons, documents reflecting office compliance sessions, non-audit office inspection reports referring to the associated persons, documents reflecting review of the associated persons' outside activities, such as tax return preparation, accounting, insurance, or sales of personal or real property, and direct communications with customers, such as activity letters or other compliance correspondence. Many other types of documents could be listed. Because many different types of supervisory systems exist, however, listing all of the different types of documents that might show defective supervision is impossible. Accordingly, the current Guide correctly requires production of all documents reflecting supervision of the associated persons, not merely the few narrow categories of such documents that are listed in new Guide.

2. Unlike the current Guide which has no provision on this point, the new Guide (List 2, Item 15) requires production of all documents relating to claimants' other investment opportunities, with no time limitation and even if the investment was not a security and the claimants did not take advantage of the opportunity. For example, if claimants consider purchasing a rental property as an investment after the filing of the Statement of Claim but decide not to do so, the new Guide requires production of all documents relating to that post-transaction investment opportunity that was not exercised. This requirement is overbroad and burdensome. It should be limited to documents relating to investment opportunities that the firm/associated persons provided to the claimants contemporaneously with the investments at issue. List 2, Item 3, of both the new Guide and the current Guide, however, already requires production of these documents that the firm/associated person provided. The separate requirement in List 2, Item 15, to produce this information should be eliminated.

3. Under the current Guide (List 2, Item 9), claimants only produce correspondence between them and respondents. Under the new Guide (List 2, Item 9), however, claimants produce all correspondence of any kind about the accounts or transactions at issue. This change would burdensomely require claimants to produce private correspondence in which they have a reasonable expectation of privacy, such as correspondence with their elderly aunt Millie which might happen to mention in passing their poorly performing investments, along with other private communications. The new Guide requires production of irrelevant information and would substantially increase the burden on claimants to search their records. This item should continue to be limited to correspondence with respondents, as the current Guide provides.

4. Under the new Guide, if respondents write to receivers about the claimants' investments, this correspondence need not be produced (List 1, Item 2), but if claimants write to Aunt Millie and mention their investment losses, then this irrelevant and private personal correspondence is produced (List 2, Item 9). This difference in treatment is unfair.

5. The most important improvement in the new Guide is the requirement that respondents produce commission runs in every case involving solicited transactions (List 1, Item 20). The current Guide only requires commission runs in churning cases (List 3, Item 1). Commission runs show the patterns of trades, the mix and type of transactions that associated persons are executing through the firm, and how much money they are making. Knowing the associated persons' mix and type of transactions is necessary to determine how they should have been supervised. In selling away cases, low commissions are a red flag that the brokers may be engaged in trading away from the firm. See Consolidated Investment Services, 58 S.E.C. Docket 699, Exchange Act Release No. ID-59, 1994 WL 707215 (Dec. 12, 1994) ("There is no evidence that CIS personnel questioned the precipitous decline in McCormick's production numbers, even though he was obligated to not 'sell-away.'"). Commission runs can show that the broker conveniently marked trades as "unsolicited" for multiple customers.

The new Guide, however, only requires commissions runs three months before and after the trades at issue. In cases involving single transactions, this time period is only six months, which is not nearly long enough. This time limitation in the new Guide will make persuading arbitrators to require production of longer commission runs more difficult. The total duration of the commission runs produced should be the same as the Guide's time period for production of claimants' tax returns—three years before the transactions at issue through the date the Statement of Claim was filed, or the length of the associated persons' employment with the firm, whichever is less.

6. Unlike the current Guide (List 2, Item 1), the new Guide requires production of Schedule A to federal tax returns and all IRS worksheets related to Schedules A, B, D, and

E (List 2, Item 1). The current Guide is already not consistent with the rule in court that a showing of compelling need is necessary to require production of tax returns. “In general, most courts have noted that public policy concerns favor keeping tax returns confidential when possible, and have ordered production only when the relevance of the information is clear and there is a compelling need.” Camp v. Correctional Medical Services, 2009 WL 424723, at *2 (M.D. Ala. Feb. 17, 2009) (citation omitted).

The new Guide expands on the current Guide and automatically requires production of IRS worksheets and Schedule A. Information on Schedule A regarding medical expenses, property, sales, and income taxes, home mortgage interest, casualty and theft losses, charitable contributions, unreimbursed employee expenses, and tax preparation fees is almost always irrelevant. Tax worksheets showing calculation of passive loss deductions for Schedule E or capital gains tax calculations for Schedule D are likewise irrelevant. Claimants commonly do not have these worksheets and may be required to get them from their accountants, thereby increasing the frustration that they already feel about FINRA’s discovery requirements. In addition, if this requirement refers only to official worksheets published by the IRS, then parties will frequently have difficulty distinguishing between IRS worksheets and the many other worksheets that tax preparation software typically generates.

7. Unlike the current Guide (List 1, Item 8), the new Guide allows respondents to redact customer complaints to prevent the disclosure of non-public personal information of the complaining customers (List 1, Item 10). This provision in the new Guide (a) should at a minimum be clarified to avoid disputes and (b) should be clarified to state that respondents should not redact complaining customers’ names and addresses. Without this clarification, respondents will in every case unilaterally redact customers’ names.

Testimony and evidence from other customers is valid evidence under Federal Rule of Evidence 404, but claimants cannot present this evidence if they do not know who the customers are. Complainants’ names are included on brokers’ CRD’s and are therefore public record. Courts have commonly required production of this information.

[W]itnesses cannot choose to “opt out” of civil discovery. “Generally, witnesses are not permitted to decline to participate in civil discovery, even when the information sought from them is personal or private.” . . . Here, many of Defendants’ complaining customers may be considered percipient witnesses to the relevant issue . . . and could therefore be considered persons having discoverable knowledge and proper subjects of discovery.

....

.... Defendants’ concern about the privacy rights of the potential class members is actually driven more by their own self-interest.

McArdle v. AT & T Mobility LLC, 2010 WL 1532334, at *4, 5 (N.D. Cal. April 16, 2010) (citations omitted).

8. The new Guide allows respondents to limit their production of audits, disciplinary records, regulatory investigations, and examination reports to activity “similar” to the conduct alleged in the Statement of Claim (List 1, Items 14, 15, 16, and 17). The new Guide likewise allows respondents to limit their production of exception reports to activity “related” to the allegations in the Statement of Claim (List 1, Item 13(b)). These requirements are not based on objective criteria and instead are based on what respondents subjectively and self-servingly think is “similar” or “related.” Similarity, to the extent it is relevant, should be determined by the arbitrators when they decide whether to allow the evidence, not unilaterally by respondents during discovery.

These provisions in the new Guide invite abuse, because respondents can and do interpret the word “similar” so narrowly that it excludes production of any misconduct. For example, respondents might say *sub silentio* that a regulatory investigation involves “similar” misbehavior only if it involves the same security and involves a transaction executed on the same day as the transaction at issue in the arbitration.

The term “similar” is vague. Indeed, Grange offers no guidance in determining what might constitute a “similar” policy and plaintiff would be left to use its own subjective criteria in speculating whether a particular policy is “similar” to the Policy. . . . [T]he Court can envision yet additional discovery disputes challenging plaintiff's chosen standards.

Chubb Custom Ins. Co. v. Grange Mut. Cas. Co., 2009 WL 243034, at *5 (S.D. Ohio Jan. 30, 2009).

Particularly in failure-to-supervise cases, all misconduct is discoverable and potentially relevant, not merely misconduct that respondents think is similar to that alleged in the arbitration. For example, heightened supervision is required for habitual offenders. “The Commission has repeatedly emphasized the need for heightened supervision when a firm employs a broker with known regulatory problems or customer complaints.” Signal Sec., Inc., Exchange Act Release No. 43,350, 73 S.E.C. Docket 928, 2000 WL 1423891, at *6 (Sept. 26, 2000). The Commission did not say here that, if associated persons have prior thefts in their background, then their employing firms need only increase their supervision for theft-related activity and that the firms need not also be specially concerned that the associated persons may injure investors in other ways, such as through unsuitable recommendations. A history of regulatory investigations requires heightened supervision for all of the associated persons’ activities, because bad brokers are likely to continue to act badly, regardless of whether the new

misconduct is “similar” to the old. A failure to provide this heightened supervision would be a basis for claimants to allege liability in a failure-to-supervise case. All misconduct should therefore be discoverable, not merely misconduct that is “similar” to the misconduct alleged in the case at hand.

9. The new Guide (List 1, Item 10) improves on the current Guide (List 1, Item 8) by not limiting production of customer complaints filed against the associated persons at issue to those complaints that are similar to the claims brought by the claimants. Unlike the current Guide, however, the new Guide limits this production to redacted complaints generated not earlier than three years prior to the first transaction at issue through the filing of the Statement of Claim. With respect to redaction, see comment 7 above. In addition, all customer complaints involving sales practice violations should be produced, not merely those within a limited time period.

10. The new Guide (List 1, Item 10) limits production of customer complaints filed against the associated persons at issue to redacted complaints generated not earlier than three years prior to the first transaction at issue through the filing of the Statement of Claim. The term “generated” is ambiguous. Does “generated” refer to the date the complaint was made or the date of the underlying events? Respondents will likely take advantage of this ambiguity to not produce responsive documents.

11. The current Guide (List 1, Item 11) requires respondents to produce all records of the firm relating to the claimants’ accounts at issue. By contrast, the new Guide eliminates this provision and instead requires respondents to produce only certain specified documents, such as account record information of basic customer data, the claimants’ risk tolerance, and customer agreements (List 1, Item 1). All of respondents’ records should continue to be produced.

12. The new Guide frequently restricts respondents’ production of records to the accounts and transactions at issue. (See, e.g., List 1, Items 2, 5, 7, and 9) Production, however, should be for all of the claimants’ accounts, not merely for the accounts at issue. As FINRA itself said in its Notice of Filing of Proposed Rule Change Amendments to the Discovery Guide and Rules 12506 and 12508 of the Code of Arbitration Procedure for Customer Disputes, dated July 28, 2010, at 11, “notes about the claimants’ other accounts may provide evidence in the case.”

13. Unlike the new Guide with respect to respondents, which requires only the production of a limited number of documents relating to the accounts and transactions at issue, the new Guide requires claimants to produce every document that they have relating to any account or transaction with the respondents (List 2, Item 5), not merely documents relating

to the accounts or transactions at issue and not merely those documents that they provided to respondents. By contrast, the current Guide, in addition to other specific requirements, only requires claimants to produce documents signed by or provided by the claimants to the respondents (List 2, Item 5). Requiring claimants to produce all of their records relating to all of their accounts, while requiring respondents to produce only some of their records relating primarily to the accounts at issue, is unfair.

14. The new Guide's catchall requirement (List 2, Item 5) for claimants to produce all documents relating to all accounts and transactions with respondents is vague and potentially covers a large number of documents with little or no relevance. Unlike industry respondents, for whom the concept of a customer record is reasonably well-defined, customer claimants will have difficulty determining what should be produced under List 2, Item 5. Does this item require production of a letter to elderly aunt Millie that mentions in passing an account or transaction not at issue and also has communications about many other irrelevant subjects? Does this item include claimants' bank account statements which reflect monthly distribution deposits from mutual fund investments not at issue, when other records of these distributions are available and when these distributions are not relevant? Given the broad encompassing nature of List 2, Item 5, other items in List 2, such as Items 3, 6, 7, 8, 10, 13, 14, 15, 18, and 19 are entirely or partially superfluous. List 2, Item 5, should be eliminated, in favor of specific items, such as Items 3, 6, 7, 8, 10, 13, 14, 15, 18, and 19 if adopted, that state directly what should be produced.

15. Unlike the old Guide (List 1, Item 2), the new Guide does not require respondents to produce monthly statements and confirmations. Because claimants commonly do not have complete records, they will have to ask for these records separately. Separate requests will lessen the likelihood of getting the statements from the arbitrators, given that the new Guide if adopted will say that monthly statements need not be automatically produced. By contrast, the new Guide requires claimants to produce their monthly statements, unless they are willing to stipulate that they received these statements (List 2, Item 4), which my clients will not do. Thus, claimants can avoid mandatory production of monthly statements only by making a potentially damaging stipulation, while respondents can avoid mandatory production of monthly statements as a matter of course. This difference in treatment is unfair.

16. Unlike the current Guide (List 5, Item 4), the new Guide limits production of regulatory examinations reports to the one year before the transactions at issue through the filing of the Statement of Claim (List 1, Item 17). In a churning case, however, for example, an examination report regarding churning conducted thirteen months before the transactions at issue or one day after the filing of the Statement of Claim is relevant and should be produced.

17. Unlike the current Guide, the new Guide requires respondents and claimants (List 1 and 2, Item 18) to produce all documents received by document request to third parties at any time during the case. When claimants' counsel, as part of their investigation, obtain documents from third parties by request rather than by subpoena, these documents are arguably work product that need not be produced, because they can show counsel's thoughts and plans. They instead are produced only at the 20-day exchange under FINRA Rule 12514, if claimants intend to use these documents. Respondents should not be able to take advantage of claimants' counsel's efforts to obtain documents that respondents were not diligent enough or did not think to get. In view of the work-product-privilege issues, this requirement in the Guide should be removed for both respondents and claimants.

18. Unlike the current Guide (List 2, Item 2), the new Guide requires production of financial statements in loan applications (List 2, Item 2). Numbers inserted in the lines of loans applications—which are usually just estimates, are commonly entered by loan brokers rather than claimants to increase the chance that the loans will be approved, and are often incorrect—are not financial statements. They do not have the rigor and care needed for preparation of proper financial statements and will be misleading to the arbitrators. The language of the current Guide should be retained on this point.

19. Under the current Guide (List 12, Item 1), telephone records and logs are produced only in unauthorized trading cases. Under the new Guide (List 2, Item 8), they are produced in every case. This change is unduly burdensome and can arguably require claimants in every case to search through their long distance phone bills for entries that show the firm/associated persons' phone numbers. In most cases, this information is not relevant. Telephone logs and listings should continue to be required only in unauthorized trading cases. Notes and recordings reflecting the substance of the telephone communications would still be produced in all cases under List 2, Items 7 and 8, of the new Guide.

20. Unlike the current Guide (List 2, Item 12), the new Guide (List 2, Item 11) requires production of non-confidential settlements of claimants' other formal civil actions and arbitrations. The new Guide further states that confidential agreements can be ordered to be produced, which means that arbitrators commonly will order their production. Cases can settle for numerous reasons unrelated to the merits. Consequently, settlement agreements will usually be irrelevant and misleading about the merits of the claim. In addition, these agreements should remain confidential when they are confidential; the Guide should not unnecessarily encourage the production of these documents which the parties intended would remain private.

21. Unlike the current Guide (Lists 8, 10, and 14, Item 1), the new Guide (List 2, Item 12) requires claimants to produce documents showing accounts over which they have

trading authority if they are also trustees. This change can require claimants to disclose private information about other persons and entities not involved in the case who have not consented to this disclosure. The trusts' investment objectives will also commonly be different from the claimants' personal objectives, so that the relevance of these documents can be marginal at best.

22. Under the current Guide (List 14, Item 2), claimants produce the documents they relied on in making the investment decisions at issue; production under the current Guide is therefore limited to pre-transaction documents. Under the new Guide (List 2, Items 13 and 15), claimants produce every document they have about the investments, even if they did not rely on them; the new Guide thus includes both pre-transaction and post-transaction documents, such as an internet article about the investment written after the filing of the Statement of Claim. The new Guide is overbroad and burdensome; List 2, Items 13 and 15, should continue to be limited to pre-transaction documents on which the claimants relied.

23. The new Guide eliminates the requirement in the current Guide for respondents to produce order tickets in unauthorized trading cases (List 11, Item 1). Order tickets, however, are essential in unauthorized trading cases, because a comparison of order tickets with telephone call times can prove that the trade was unauthorized.

24. The new Guide requires respondents (List 1, Item 12) to produce only those analyses and reconciliations that were prepared during the time period at issue, but requires claimants (List 2, Item 6, in its most natural reading) to produce all analyses and reconciliations prepared at any time, relating to accounts or transactions at respondents during the time period at issue. The new Guide therefore arguably requires claimants—but generally not respondents—to produce analyses protected by the work product privilege. This difference in treatment is unfair.

25. The new Guide (List 2, Item 16) retains the requirement from the current Guide (List 8 and 10, Item 2, and List 14, Item 3) for claimants to produce resumes or, if resumes do not exist, a description of claimants' educational and employment background. Claimants seldom have resumes, but, when they do, the resumes typically present an exaggerated picture of the claimants' abilities and qualifications. Claimants' self-promotional efforts in the employment arena, designed to improve their chances for employment by prospective employers, are misleading, prejudicial, and irrelevant in the context of securities arbitrations. Resumes also commonly contain information that is clearly irrelevant, such as claimants' hobbies or entertainment interests. The better approach here is to combine List 2, Items 16 and 17, of the new Guide and directly require claimants to describe their educational and employment background, while still allowing production of resumes as an alternative.

26. The provisions in the new Guide regarding confidentiality are fine as far as they go, but they do not go nearly far enough, and more guidance is needed. Respondents now file confidentiality demands in almost every case. Arbitration panels are rendering substantially inconsistent rulings on this issue.

Respondents routinely want every document they produce to remain confidential. The new Guide therefore should—but does not—include the statement from the April 2004 *Neutral Corner* article, “Arbitrators and Orders of Confidentiality,” that “[a]rbitrators should not routinely designate all discovery as confidential.” “It is well-established that . . . the fruits of pretrial discovery are, in the absence of a court order to the contrary, presumptively public.” Meyer v. Schwarzenegger, 2009 WL 1020838, at *1 (E.D. Cal. April 14, 2009) (citation omitted). In addition, contrary to most respondents’ views, compliance manuals are not confidential. “Given the[] external requirements to compile and make available internal regulations, [Smith Barney] and Shearson cannot support an argument of confidentiality or privilege” for compliance manuals. Miller v. Smith Barney, Harris Upham & Co., 1986 WL 2762, at *6 (S.D.N.Y. Feb. 27, 1986).

27. A repeated and critical ambiguity in the new Guide is the meaning of the phrase “associated persons.” At various times, the phrase in List 1 appears to refer to (a) associated persons who are parties in the arbitration and must produce documents to claimants (see, e.g., the title to List 1 or the last sentence of Item 2); (b) employees of the firm who dealt with or were connected in some way to the claimants or their transactions (Items 5, 8, 9, and 10); (c) the primary registered representatives assigned to the claimants’ accounts (Items 9, 20, and 21); or (d) any persons associated with the firm (Items 13(b) and 15). At times, the precise meaning of the phrase is very unclear. (See, e.g., Item 16)

The biggest point of contention will likely be List 1, Items 13(b), 15, and 16. Under a reasonably natural reading of the phrase “associated persons” in List 1, Item 13(b) (but see comment 8 above), respondents would be required under the new Guide to produce exception reports regarding suitability in Florida suitability cases involving Florida associated persons that were generated in Alaska for Alaska associated persons. To avoid disputes, the new Guide should clarify what the phrase “associated person” means.

Thank you for allowing me to submit these comments.

Sincerely

/s/ Stephen Krosschell