

FINRA Amendments to Discovery Guide: Need-to-Know Info for Claims

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In November 2013, the Financial Industry Regulatory Authority (FINRA) issued Regulatory Notice 13-40 which highlights the recent approval by the Securities and Exchange Commission (SEC) of amendments to the Discovery Guide used in customer arbitration proceedings. These amendments, which became effective for all customer cases filed on or after December 2, 2013, significantly alter the existing discovery standards for securities claims. Professionals handling these claims will benefit by understanding three key components of the amendment's impact.

First, the amended guide provides guidance on resolving electronic discovery (e-discovery) disputes. Second, the amendments clarify the circumstances under which a party may request an affirmation when an opposing party does not produce documents. Third, the amendments explain how "product cases" are different from other customer cases and describe the type of documents that parties typically request in product cases.

For background, FINRA sponsors an arbitration forum whereby most disputes brought by retail public customers in the securities industry are adjudicated. The FINRA arbitration system does not expressly impose upon its arbitration panels the Rules of Civil Procedure from the federal courts or the relevant state courts. Rather, the arbitrators are typically given discretion to decide discovery related issues with limited guidance from FINRA. The one notable exception in this regard has been the various versions of the Discovery Guide which set forth, among

other things, standardized lists of documents considered presumptively discoverable. These amendments to the Discovery Guide are the first significant changes to the guide since May 16, 2011.

Form of Production

With respect to e-discovery, the amended Discovery Guide now includes a section titled "form of production," whereby parties are encouraged to discuss the forms in which they intend to produce documents and, whenever possible, agree to the form of production. However, parties must produce electronic files in a "reasonably usable format."

As noted by the amendment, "the term reasonably usable format refers, generally, to the format in which a party ordinarily maintains a document, or to a converted format that does not make it more difficult or burdensome for the requesting party to use in connection with the arbitration." Arbitrators are also given guidance as to resolving contested motions relating to the form of production, and are instructed to consider the totality of the circumstances including whether the chosen form of production is different from the form in which a document is ordinarily maintained.

For documents that must be obtained from a third party, arbitrators consider whether the chosen form of production is different from the form in which the third party provided it. In regard to documents converted from their original format, arbitrators consider a party's reasons for choosing a particular form of

production, how the documents may be affected by the conversion to a new format, and whether the requesting party's ability to use the documents is diminished by a change in the documents' appearance, searchability, metadata, or maneuverability.

Expanded Affirmation

The amended Discovery Guide also provides additional guidance as to affirmations in the event a party does not produce documents specified in the document production list. Originally, the guide specified that when a party responds that there are no responsive documents, upon the request of the party seeking the documents, an affirmation must be executed stating that a good faith search for the requested documents was conducted—including a description of the extent of the search—and state (based upon the search) that there are no requested documents in the party's possession, custody or control. This language has now been slightly expanded to require affirmations in situations involving a partial production. If a party does not produce a document specified in a list item, the requesting party may ask for an affirmation in writing indicating that the party conducted a good faith search for the requested document. The party is also required in the affirmation to state the sources searched.

Guidance on Product Cases

Finally, FINRA amended the Discovery Guide's introduction to add guidance on product cases. As explained by regulatory Notice 13-40, product cases are unique customer cases that differ from others in several ways. In particular, a product case is one in which one or more of the asserted claims centers around allegations regarding the wide spread mis-marketing or defective development of a specific security or specific group of securities. This item is particularly relevant given the recent wave of FINRA arbitrations involving real estate based private placements such as tenant in common (TIC) interests and real estate investment trusts (REIT). In these types of arbitrations, claimants typically allege a systemic failure to conduct

adequate due diligence on the product itself, failure to provide full and balanced disclosure of both risk and rewards, failure to implement appropriate internal controls, and failure to train registered persons regarding the features, risks and suitability of these products.

The amended Discovery Guide explains that the two existing document production lists may not provide all of the documents that parties typically request in a product case relating to a firm's creation of a product, due diligence reviews of a product, training on or marketing of a product, or post-approval review of a product. The guide also now emphasizes that parties are not limited to the documents enumerated in the lists; however, when parties do not agree on whether a case is a product case, the arbitrator may ask the parties to explain their rationale for that assertion. It is important to also note that FINRA does provide additional guidance to arbitrators in determining whether a specific matter is a product case, as they are differentiated from other customer cases in the following ways:

1. The volume of documents tends to be much greater.
2. Multiple investor claimants may seek the same documents.
3. The documents are not client specific.
4. The product at issue is more likely to be the subject of a regulatory investigation.
5. The cases are more likely to involve a class action with documents subject to a mandatory hold.
6. The same documents may have been produced to multiple parties in other cases involving the same security or to regulators.
7. Documents are more likely to relate to due diligence analysis performed by persons who did not handle the claimant's account.

In challenging whether the arbitration constitutes a product case, parties should be prepared to address whether any of these seven items apply to the arbitration before the panel. To be clear, the amended guidelines only apply to customer arbitration proceedings and do not apply to intra-industry cases.

Providing useful guidance as to the parameters of permissible discovery in public customer arbitrations has been an ongoing task for FINRA for more than a decade. The scope of permissible discovery has been a topic of

renewed discussion culminating in these most recent amendments. Professionals handling securities claims must be cognizant of these changes and diligent in managing these claims to avoid potential pitfalls that may arise at the discovery stage.



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