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SECURITIES AND COMMODITIES LITIGATION AND ARBITRATION

INVESTOR RIGHTS

STOCKBROKER MISCONDUCT

April 3, 2009

Via e-mail to rule-comments@sec.gov

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

Re: File Number SRFINRA-2008-024

Dear Ms. Murphy:

We are writing to comment on File Number SRFINRA-2008-024, in which FINRA proposes to amend its *Discovery Guide* production lists. This amendment would substantially increase the burden on investors to produce irrelevant documents and information, while decreasing the requirements for industry parties to produce relevant documents. The amendment would materially increase the likelihood that investors will lose their arbitration claims, because they would have less access to the documents and information they need to prove their claims, while providing industry parties with greater access to irrelevant information to use to attack investors and put investors–rather than the industry parties–on trial.

The proposed amendment violates Section 15A(b)(6) of the Securities Exchange Act of 1934, 15 U.S.C. § 78o–3(b)(6), which requires that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The amendment does not protect investors and in fact hurts them. Although the amendment makes some minor changes that benefit investors, these changes are largely inconsequential. Accordingly, the Commission should reject the amendment in its entirety.

Proposed List 4–Failure to Supervise

In recent years, our firm has filed and prevailed on many selling away claims in arbitration against brokerage firms. When firms are negligent in failing to detect and prevent unapproved private securities transactions, they can be liable for negligent supervision and can be liable as controlling persons under the securities laws. Supervision is a key issue and sometimes the only issue in selling away cases, which commonly involve remote offices. The Commission has frequently brought enforcement actions alleging lack of supervision of these offices.

> Some broker-dealer firms have geographically dispersed offices staffed by only a few people, and many are not subject to onsite supervision. Their distance from compliance and supervisory personnel can make it easier for registered representatives (representatives) and other employees in these offices to carry out and conceal violations of the securities laws. The supervision of small, remote offices, therefore, can be especially challenging. The Commission staff has examined branch offices and the Commission has brought numerous enforcement cases involving inadequate supervision of these small, remote offices. These cases address situations in remote offices where supervisory mechanisms failed to detect and prevent misconduct.

Staff Legal Bulletin No. 17 (Remote Office Supervision), 2004 WL 3711970, at *2 (SEC Mar. 22, 2004).

In our selling away cases, firms commonly do not have documents relating to our clients, and the issue is what the documents show that the firm did to supervise the brokers and to detect and prevent the fraud that occurred. Accordingly, we are substantially concerned about the dramatic reduction in the requirements in the new document production lists for firms to produce supervision-related documents.

List 5, Item 2, of the *Discovery Guide* presently requires firms, in cases involving failure to supervise, to produce "all . . . documents reflecting supervision of the Associated Person(s) and the customer's account at issue." The new List 4 would completely delete this requirement. It instead requires only narrow and limited categories of documents relating to supervision of the associated person to be produced–exceptions reports for the associated person generated one year before or after the transactions at issue (Item 2), internal audit reports relating to the associated person generated one year or after the transactions at issue (Item 3), documents reflecting conversations between the associated person and the firm's compliance department (Item 4), regulatory inquiries relating to "similar" conduct by the associated person (Item 5), portions of regulatory examination reports relating to the associated person or "similar" conduct at the branch (Item 6), notes reflecting supervisory review of the customer's account (Item 7), and correspondence between the customer and the firm/associated person bearing indications of supervisory review. (Item 8).

This narrow and limited production of documents relating to supervision is wholly 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, proposed List 4 does not require production of the following documents that are presently required: documents reflecting compliance meetings between the brokers 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 brokers, documents reflecting office compliance sessions, non-audit office inspection reports referring to the brokers, documents reflecting review of the brokers' 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, but listing all of the different types of documents that might show defective supervision is impossible. Accordingly, the current document production lists correctly require production of all documents reflecting supervision of the broker, not merely the few narrow categories of such documents that are listed in the proposed amendment to the *Discovery Guide*.

If the SEC, FINRA, or state regulators were concerned that brokers at a firm's office were defrauding customers without proper supervision from the firm, regulators would not limit themselves to looking at only a few limited categories of supervision-related documents. Instead, they would insist on looking at all of these documents. For example, they would not look only at a meager two years of internal audit reports and would not allow the firms to disclose only those portions of the internal audit reports that discussed conduct the firms self-servingly believed was "similar" to the conduct at issue. Firms could not refuse to disclose audit reports showing theft by the brokers, on the ground that the thefts were not "similar" to the unsuitable recommendations that were the subject of the regulatory inquiry. Similarly, firms could not refuse to disclose these audit reports, on the ground that the theft had occurred 13 months before the transaction at issue.

Indeed, the very idea is ludicrous that firms could conceal evidence of supervisory failure from regulators on this basis. Yet, FINRA, by promulgating the new proposed *Discovery Guide*, evidently believes that investors are not entitled to this same information which is clearly relevant and which FINRA itself would always obtain for its own regulatory inquiries. As this theft example illustrates, all evidence of supervisory failure is relevant in a failure-to-supervise case, not merely the few limited categories of supervision-related documents listed in the proposed new List 4 the *Discovery Guide*.

Proposed List 1, Items 6 and 10–Complaints that are "Similar"

List 1, Items 6 and 10, of the proposed *Discovery Guide* continues the provision in the prior *Guide* that firms need only produce customer complaints and disciplinary actions against the brokers that reference conduct that is "similar" to the conduct at issue in the arbitration. This requirement is not based on objective criteria and instead is based on what the firm subjectively and self-servingly thinks is "similar." This provision therefore invites abuse, because firms can and do interpret the word "similar" so narrowly that it excludes production of any customer complaints and disciplinary actions. For example, a brokerage firm lawyer might say *sub silentio* that a complaint is "similar" only if it involves the same security and involves a transaction executed on the same day as the transaction at issue in the arbitration.

Particularly in failure-to-supervise cases, all complaints and disciplinary actions are discoverable and potentially relevant, not merely those that allege conduct that the brokerage firm thinks is similar to that alleged in the arbitration. For example, heightened supervision is required for habitual offenders. "[T]he Commission would expect a broker-dealer to consider providing heightened supervision for a registered representative with a history or pattern of customer complaints, disciplinary actions or arbitrations." Order Approving Proposed Rule Change Relating to Supervision and Record Retention Rules, 1997 WL 796926, at *5, Exchange Act Release No. 39,510, 66 S.E.C. Docket 469 (Dec. 31, 1997). The Commission did not say here that, if brokers 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 brokers may injure investors in other ways, such as through unsuitable recommendations. A history of customer complaints requires heightened supervision for all of the brokers' activities, because a bad broker is 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 substantial basis for investor to allege liability in a failure-to-supervise case. All complaints and disciplinary actions should therefore be discoverable, not merely those that are "similar" to the case at hand.

Proposed List 4, Item 1–Commission Runs

Proposed List 4, Item 1, continues only to require commission runs relating to the customers' accounts. Full commission runs should be required in every case and particularly those that involve lack of supervision, because they show the patterns of trades that brokers are executing through the firm and how much money they are making. For example, in selling away cases, low commissions are a substantial 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.'"). Similarly, commission runs can show that the broker conveniently marked trades as "unsolicited" for multiple customers. Full commission runs are relevant in a multitude of ways and should be produced in every case.

Proposed List 2, Item 12–Loan Agreements

Perhaps the single most obnoxious change in the proposed new *Discovery Guide* is the requirement in List 2, Item 12, for investors to identify all loans they have sought over as long as an 11-year period, to produce loan agreements, and to provide written authorizations for industry respondents to obtain the loan applications directly from the lenders. In our practice, industry parties periodically request these loan-related documents. We always object, and the arbitrators generally sustain the objection. To the extent that the industry party seeks identification of all prior loan applications, we always object to the request as an improper interrogatory which requires improper fact finding and is generally not allowed in arbitration. The arbitrators sustain this objection as well. The new *Discovery Guide*, by requiring interrogatory-like answers and production of loan applications, would substantially overturn current practice in FINRA arbitrations.

Our clients are commonly elderly and do not remember every detail of their credit card applications, home mortgages, and automobile loan requests. We ourselves would have difficulty remembering these details. Requiring elderly investors to pore over their files and dredge into their memory to provide this information would be burdensome and frustrating for many of them and could have a chilling effect on their desire to proceed with their arbitation. They already believe that, merely by filing an arbitration claim alleging that they were defrauded, they should not have to give up their privacy rights and should not have to produce every last detail of their financial lives. Now, under the proposed *Discovery Guide*, they would have to produce 11-year-old credit card applications and sign releases in advance for release of this information directly to their opponent in the arbitration.

These unnecessary requirements will merely increase their view that they are being victimized again, when they undergo the arbitration process. The *Discovery Guide* already requires them to produce substantial information about their financial affairs, such as tax returns, financial statements, and brokerage firm account statements. Industry parties can obtain from these documents an adequate and sufficient picture of the claimants' financial situation. Requiring production of still more financial documents would be burdensome and cumulative.

For most purposes in securities arbitrations, what counts is what the brokers knew about the claimants' financial situation. If the brokers had not seen the credit card application when they made their recommendation, then the application is irrelevant. For this reason, the court in Rauscher Pierce Refsnes, Inc. v. Flatt, 670 So. 2d 537, 541 n.7 (La. Ct. App. 1996), found that NASD arbitrators correctly did not admit tax returns as evidence.

> The National Association of Securities Dealers, Inc., a securities self-regulatory agency, promulgated the following "suitability" rule: "In recommending to a customer the purchase, sale, or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of facts, if any, **disclosed by such customer**, as to his security holdings and as to his financial situation and needs." (Emphasis added).

> Flatt testified that he had not disclosed his tax returns to Rauscher before his purchase of the Entronics stock. If Rauscher had not viewed Flatt's returns, it is unclear how they could now be used to prove Rauscher used them as a basis for their recommendation to Flatt.

In FINRA arbitrations, industry parties already get substantial financial information about the claimants through production of tax returns, financial statements, and brokerage firm account statements. Additional information about their finances, such as loan applications, is unnecessary, burdensome, invasive, and not relevant, because the brokers usually did not see the loan applications when they made their recommendations. If they did see these applications, then the industry parties already have them and do not need them again from the arbitration claimants.

Proposed List 2, Items 1, 2, and 4–Eleven Years of Tax Returns, Financial Statements, and Brokerage Firm Account Statements, and Required Answers to a FINRA-Propounded Interrogatory

Proposed List 2, Items 1, 2, and 4 would require investors to produce as much as 11 years of tax returns, financial statements, and brokerage firm account statements. Item 4 additionally requires investors to respond to a mandatory interrogatory, by identifying their prior brokerage firms, and to provide a written release authorizing their opponent in the arbitration to obtain account statements directly from the prior brokerage firms. Here again, the increased number of years is unnecessary, burdensome, cumulative, and invasive. This expansive mandatory production of as much as 11 years of documents certainly compares unfavorably to the skimpy two years of partial internal audits that the brokerage firm is required to produce in List 4, Item 3. Merely by filing an arbitration claim, victimized investors should not have to give up their privacy rights and should not have to produce every conceivable piece of financial information. In addition, mandatory interrogatories that require fact finding of this nature are inconsistent with the purpose of arbitration to provide a speedy and less expensive alternative to litigation. FINRA Rule 12507(a) expressly states that "fact finding" is not required in response to information requests and that "interrogatories are generally not permitted in arbitration."

Proposed List 1, Item 2–Deletion of Requirement to Produce Account Statements

Proposed List 1, Item 2, deletes the requirement for industry parties to produce monthly statements, evidently on the theory that the customers already have them. Customers, however, do not always keep every monthly statement, and these statements are fundamental to every case in which they were issued to customers. These documents are textbook examples of "presumptively discoverable" documents that should be produced in every case.

Proposed List 1, Item 2, and List 2, Item 9–Correspondence

Proposed List 1, Item 2, continues the requirement that industry parties need only produce correspondence between the customer and the firm relating to the transaction at issue. By contrast, proposed List 2, Item 9, requires customers to produce all correspondence to anyone relating not only to their transactions but also to their accounts. No reason exists to require customers to produce all correspondence about their transactions and their accounts while industry parties need only produce transaction-related correspondence. Similarly, if industry parties write to third parties about the claimants, this correspondence need not be produced, but if investors' Aunt Millie writes to them and happens to mention in passing their losses in their brokerage accounts, then this irrelevant and private personal correspondence from an elderly relative must *presumptively* and *automatically* be produced to the brokerage firm, even if the firm did not request it.

The proposed changes in the *Discovery Guide* are again reaching far afield from the core documents that are relevant to all cases. These changes relating to correspondence also again illustrate the pervasive differences in treatment in the *Discovery Guide* that favor industry parties.

Proposed List 1 and List 2, Item 8–Recordings

Another example of the *Discovery Guide*'s bias in favor of industry parties is the proposed deletion of the former requirement in List 1 to produce recordings of telephone calls, while still requiring investors in List 2, Item 8, to produce these recordings. Recordings seldom exist, but, when they do exist, they are always fundamental. Once again, no reason exists to allow brokerage firms to conceal recordings which are potentially harmful to their case, while requiring investors to produce them even if they are irrelevant.

Proposed List 1, Item 8, and List 2, Item 6–Account Analyses and Reconciliations

The proposed *Discovery Guide* again treats industry parties favorably in comparison to investors, when it limits the industry parties' requirement in List 1, Item 8, to produce account analyses and reconciliations to those documents prepared during the time period at issue and limits production of these documents to those that were prepared for accounts. By contrast, List 2, Item 6, requires customers to produce these documents that were prepared at any time, not merely during the time period at issue, and requires production of these documents for transactions as well as accounts. Once again, no reason exists for this difference in treatment which favors industry parties.

Proposed List 1–Holding Pages

Proposed List 1 deletes the former requirement to produce holding pages or their electronic equivalents. Although firms today may not always have holding pages, many of them do still have these pages or their electronic equivalents. Firms should be required to produce these pages if they still have them, for all of the reasons that production of these documents has always been required. Holding pages provide relevant information regarding whether the broker sold the product to all or many customers, the percentage of the broker's business allocated to the product, and the nature of any other securities sold to the investor.

Proposed List 1, Items 15 and 16–Resumes and Educational and Employment Background

Proposed List 1, Items 15 and 16, retains the requirement to produce resumes or, if a resume does not exist, a description of the investors' educational and employment background. Our clients seldom have resumes, and, when they do, the resumes typically present an exaggerated picture of the clients' abilities and qualifications. They also commonly contain information that is not relevant to the arbitration, such as the investors' hobbies or entertainment interests. As such, they are not helpful to arbitrators. Arbitrators are looking for the truth and are not looking for individuals' self-promotional efforts in the employment arena, designed to improve their chances for employment by prospective employers. The better approach here is to combine items 15 and 16 and directly require investors to describe their educational and employment background, while still allowing production of resumes as an alternative.

Thank you for allowing us to submit these comments.

/s Stephen Krosschell
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