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FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. Respondent.	Disciplinary Proceeding No. 2011029760201 Hearing Officer—LOM **ORDER DENYING RESPONDENT'S MOTION FOR LEAVE TO SERVE LIMITED DISCOVERY**

ISSUE

FINRA's[1] Department of Enforcement ("Enforcement") brought this disciplinary action against Respondent ("Respondent" or "the Firm") on February 1, 2012. Pursuant to FINRA Rule 9251(a)(3), Respondent filed a motion seeking permission to serve ten requests for document production upon Enforcement.[2] Enforcement filed an opposition.[3] For the reasons set forth below, the Hearing Officer denies Respondent's Motion.

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[1] The Financial Industry Regulatory Authority, Inc. ("FINRA") is responsible for regulatory oversight of securities firms and associated persons who do business with the public. FINRA was formed in July 2007 by the consolidation of NASD and the regulatory arm of the New York Stock Exchange ("NYSE"). FINRA is developing a new "Consolidated Rulebook" of FINRA Rules that includes NASD Rules. The first phase of the new consolidated rules became effective on December 15, 2008. *See* FINRA Regulatory Notice 08-57 (Oct. 2008). Because the Complaint in this case was filed after December 15, 2008, FINRA's procedural Rules apply to the proceeding. The applicable FINRA and/or NASD conduct Rules are those that existed when the conduct in issue occurred. FINRA's Rules (including NASD Rules) are available at www.finra.org/Rules. References here to FINRA include the NASD.

[2] On March 23, 2012, Respondent filed its motion titled "[Respondent's] Motion For Leave To Serve Limited Discovery" (the "Motion").

[3] On March 30, 2012, Enforcement filed its opposition titled "Department Of Enforcement's Opposition To [Respondent's] Motion For Leave To Serve Limited Discovery" (the "Opposition").

NATURE OF CASE[4]

This disciplinary action concerns new provisions in the Firm's customer account agreements that require any customer claim to be arbitrated on an individual basis.[5] Under the new provisions, a customer waives any right to assert a claim against the Firm as a class or representative action, either in court or in arbitration. In addition, a customer agrees that FINRA arbitrators shall have no authority to proceed in arbitration on a representative or class action basis or to consolidate more than one party's claims. Enforcement contends that these provisions improperly "limit" and "conflict with" two FINRA arbitration Rules, one that contemplates the existence of judicial class actions and sets forth procedures for avoiding the arbitration of claims that are subject to a class action, and another that provides for joinder of customer claims in arbitration in some circumstances. Enforcement alleges that such "limits" and "conflicts" violate two FINRA conduct Rules that prohibit members from imposing certain conditions on pre-dispute arbitration, along with a FINRA conduct Rule requiring compliance with just and equitable principles of trade. Respondent contends that the new provisions do not "limit" or "contradict" FINRA Rules, and, in any event, even if they did, that the Federal Arbitration Act ("FAA") preempts FINRA's ability to enforce its Rules with respect to the new provisions in the Firm's customer agreements.

The critical facts are not in dispute. According to Enforcement's Complaint, and as admitted in Respondent's Answer, the Firm amended its customer account agreement in October 2011 to include what the Firm styles a "Waiver of Class Action or Representative Action" ("Waiver") as part of its pre-dispute arbitration agreement. The Firm sent the Waiver to almost

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[4] This is a summary of the case based on a preliminary review of the Complaint, Answer, Motion, and Opposition.

[5] The new provisions also bind the Firm to assert any claim against the customer as an individual claim in arbitration, but that aspect of the agreement is not in issue.

seven million existing customers (6.8 million). The Firm also included the Waiver in customer account agreements for new customer accounts opened on or after October 1, 2011. Since then, tens of thousands of new customers have opened accounts with the Waiver included in the customer account agreement. Compl. ¶¶ 1, 12, 13, and 14. Answer ¶¶ 1, 12, 13, and 14.

According to the Complaint (¶ 13), and as admitted in the Answer (¶ 13), the Waiver provides:

> Neither you nor [the Firm] shall be entitled to arbitrate any claims as a class action or representative action, and the arbitrator(s) shall have no authority to consolidate more than one parties' [sic] claims or to proceed on a representative or class action basis.
>
> You and [the Firm] agree that any actions between us and/or Related Third Parties shall be brought solely in our individual capacities. You and [the Firm] hereby waive any right to bring a class action, or any type of representative action against [the Firm] or any Related Third Parties in court. You and [the Firm] waive any right to participate as a class member, or in any other capacity, in any class action or representative action brought by any other person, entity or agency against [the Firm] or you.

Enforcement alleges that the Waiver violates two FINRA conduct Rules (and their prior NASD versions) that impose restrictions on members' pre-dispute arbitration agreements. FINRA Rule 2268(d)(3), which became effective on December 5, 2011, and its predecessor, NASD Rule 3110(f)(4)(c), both prohibit a member from placing "any condition" in a pre-dispute arbitration agreement that "limits the ability of a party to file any claim in court permitted to be filed in court under the rules of the forums in which a claim may be filed under the agreement." Compl. ¶¶ 3, 16. FINRA Rule 2268(d)(1), which also was effective on December 5, 2011, and its predecessor, NASD Rule 3110(f)(4)(A), both prohibit a member firm from placing "any condition" in a pre-dispute arbitration agreement that "limits or contradicts the rules of any self-regulatory organization." Compl. ¶ 5.

Enforcement further contends that "by virtue of these violations" Respondent also violated FINRA Rule 2010. Compl. ¶¶ 20, 26, and 32. FINRA Rule 2010 requires the observance of "high standards of commercial honor and just and equitable principles of trade."

Enforcement points to two FINRA Rules in the Code of Arbitration Procedure, Rule 12204 and Rule 12312, as the sources of the alleged limits or conflicts giving rise to the violations. It brings three Causes of Action against Respondent.

In the First Cause of Action, Enforcement focuses on FINRA arbitration Rule 12204, which provides that a firm may not enforce an arbitration agreement against a member of a certified or putative class action until and unless the person is no longer a participant in a class action (as where class certification is denied, the putative class is decertified, or the person has opted out of the class). Compl. ¶ 18. Enforcement alleges that FINRA conduct Rule 2268 requires these class action disclosures to be made in customer agreements. Compl. ¶ 19. Enforcement concludes that Respondent's Waiver is an improper attempt "to limit" the customer's ability to bring the class actions contemplated in these provisions. Compl. ¶ 20.

In the Second Cause of Action, Enforcement also focuses on FINRA arbitration Rule 12204. Enforcement asserts that customers can bring and participate in class actions in the manner set out by Rule 12204 and that the Firm's attempt to foreclose participation in class actions by its Waiver "limits and contradicts" Rule 12204 in violation of FINRA conduct Rule 2268(d)(1) and its predecessor NASD Rule 3110(f)(4)(A). Compl. ¶ 26.

Finally, in the Third Cause of Action, Enforcement highlights FINRA arbitration Rule 12312. Rule 12312(a) provides that "one or more parties may join multiple claims together in the same arbitration." Compl. ¶ 30. The Rule specifies the circumstances in which joinder is permitted – where the claims "contain common questions of law or fact," and either the

claimants seek joint and several relief or the claims arise out of the same transaction or series of transactions. Rule 12312(a). As Enforcement notes, pursuant to Rule 12312(b), before an arbitration panel is appointed, the Director of Arbitration is empowered to separate two or more arbitrations that have been joined, and after an arbitration panel is appointed the panel is vested with that power. Compl. ¶ 30.

DISCUSSION

A. FINRA Rule 9251

FINRA disciplinary proceedings have "unique characteristics" and are governed by FINRA's own procedural Rules, the Rule 9000 Series, not the Federal Rules of Civil Procedure. *See* OHO Order 01-04 (CAF000045), 2001 NASD Discip. LEXIS 7, at *25-26 (Feb. 14, 2001) (in assessing, and rejecting, Enforcement's attempt to use a Rule 8210 request as a discovery tool, "the Hearing Officer cannot overlook the unique characteristics of disciplinary proceedings under the NASD Code of Procedure [predecessor of the FINRA Rules]"); FINRA Rule 9110(a). FINRA disciplinary proceedings are not governed by the Federal Rules of Evidence. FINRA Rule 9145(a). A Hearing Officer is empowered to admit relevant evidence and exclude "irrelevant, immaterial, unduly repetitious, or unduly prejudicial" evidence. FINRA Rule 9263(a).

FINRA procedural Rule 9251 governs the limited document "discovery" that Enforcement is required to make to the respondent in a FINRA disciplinary proceeding. FINRA Rule 9251(a)(1) provides that Enforcement must make available to the respondent for inspection and copying the "[d]ocuments prepared or obtained by Interested FINRA Staff in connection with the investigation that led to the institution of proceedings." That provision identifies examples of such documents, including requests for information to FINRA member firms and

associated persons pursuant to FINRA Rule 8210, requests for information to other persons not employed by FINRA, and documents that FINRA staff may have obtained by such requests. Other examples include transcripts and transcript exhibits and all other documents obtained from persons not employed by FINRA.

FINRA Rule 9251(a)(1) limits the documents Enforcement is required to produce to a respondent in two ways. *First*, only documents prepared or obtained by "Interested FINRA Staff" are required to be produced. FINRA Rule 9120(t) defines "Interested FINRA Staff" as certain FINRA employees with authority or involvement in an examination, investigation, prosecution or litigation relating to the specific disciplinary proceeding. *Second*, only documents prepared or obtained in connection with the investigation giving rise to the complaint must be produced. Under Rule 9251(a)(1), document production is narrowly focused on evidence that is directly relevant to the particular disciplinary proceeding against respondent. *See Dep't of Enforcement v. Reichman*, Compl. No. 200801201960, 2011 FINRA Discip. LEXIS 18 (NAC July 21, 2011) (denial of discovery from Enforcement upheld as fair, where respondent sought information regarding larger investigation that was not relevant to narrow issues of case against respondent).

Separately, Rule 9251(b) also permits Enforcement to withhold (among other items): documents that are privileged, examination reports and other internal memoranda and notes prepared by FINRA employees, and documents that would disclose investigatory or enforcement techniques and guidelines. The focus of this provision is largely on protecting internal documents and communications. A respondent is not given access to Enforcement's legal theories or FINRA's internal workings during an investigation.

However, FINRA Rule 9251(a)(3) provides flexibility. It expressly states that nothing in Rule 9251(a)(1) limits the discretion of Enforcement to make other documents available or the authority of a Hearing Officer to order the production of any other document. The Rule provides no specific standard for exercise of the Hearing Officer's authority to expand the scope of production beyond what is required.

Respondent's Motion relies upon the Hearing Officer's authority under FINRA Rule 9251(a)(3) to order production of other documents in addition to those required to be produced under FINRA Rule 9251(a)(1).

B. <u>Respondent's Document Requests</u>

Respondent seeks permission pursuant to FINRA Rule 9251(a)(3) to issue ten requests for production of documents to Enforcement. The term "document" is broadly defined in a fashion typical of civil discovery to include a long list of items "without limitation." To paraphrase and shorten, the term includes printed, handwritten, recorded, filmed, electronic or hard copy items – whether master, original or copy. The term includes agreements, communications, correspondence, facsimiles, emails, notes, memoranda, summaries of personal conversations and minutes of conferences, books, calendars, diaries, and marginal notations "in your possession, custody, or control."

Respondent's individual requests are similarly all-encompassing. In general, they seek all documents that "contain or refer" to communications, both public and non-public, that "discuss" or even "mention" whether the Rules at issue have the "intent, meaning or purpose" of prohibiting members from adopting class action waivers. For convenience, in summary form, they are set forth below:

Request No. 1 seeks communications between FINRA and present or former members regarding the meaning of the Rules at issue.

Request No. 2 seeks communications between FINRA and the public regarding the meaning of the Rules at issue.

Request No. 3 seeks all documents that "show any actual or threatened disciplinary action by FINRA on the subject of a class action waiver."

Request No. 4 seeks communications between FINRA and the SEC regarding the meaning of the Rules at issue.

Request No. 5 seeks all documents "which are part of or which discuss or refer to the rule-making history of the Rules" and which "show any intent or purpose of the rules as barring members from adopting class action waivers."

Request No. 6 seeks all documents "generated within NASD or FINRA" that "inform any of their officers, investigators, auditors or other employees" that the Rules bar members from imposing class action waivers on customers.

Request No. 7 seeks any document "whether internal or external" that "evidences" any FINRA interpretation of the Rules applying to customer class action waivers.

Request No. 8 seeks any document "whether circulated internally or externally" in which FINRA ever interpreted the Rules in issue to bar members from adopting customer class action waivers.

Request No. 9 seeks any document on which FINRA relies that a "claim" includes "class action."

Request No. 10 seeks "[a]ll emails, memoranda, analyses or other communication to or from [JD] prior to his letter to [the Firm] of October 20, 2011, which discusses why, how or

whether the Rules prohibit member firms from adopting class action waivers in customer agreements."

C. Respondent's Arguments For Issuing Its Document Requests

Respondent asserts that its document requests "are intended to lead to the discovery of admissible evidence on its defenses." Motion at 2. It contends that "factual questions" are central to this case. Those "factual questions" have to do with FINRA's "interpretation of the Rules at issue" and any communications with the SEC, member firms, or internally regarding that interpretation. Respondent seeks "to discover FINRA's internal and external communications about the meaning of the subject rules." Respondent declares that if it is not permitted that discovery it will be "severely prejudiced in proving that FINRA has acted improperly." Motion at 2.

Respondent states that its document requests are intended to gather support for two affirmative defenses. One defense is that FINRA failed to give fair and reasonable notice of its interpretation of the Rules to bar the customer class action waiver in issue in violation of due process. Motion at 2-4. The other defense is that "a rule 'requiring' the availability of classwide proceedings 'interferes with fundamental attributes of arbitration and thus creates a scheme inconsistent with the FAA.'" Motion at 5.

D. Enforcement's Arguments Against Expanded Discovery

Enforcement represents that it has provided Respondent with the discovery to which it is entitled under FINRA Rule 9251. Opposition at 2 and note 5. Respondent has not disputed that Enforcement has done so. Enforcement asserts that documents outside the scope of required discovery are presumptively not discoverable. Opposition at 2, note 3. Accordingly, Enforcement argues that Respondent's document requests should be denied.

In addition, Enforcement argues that Respondent's requests are not appropriate for discovery to the extent that the Firm seeks publicly available documents and documents supporting legal arguments and contentions. Enforcement also argues that requests for internal communications should be denied because FINRA Rule 9251(b) permits Enforcement to withhold internal communications and because, in any event, they are not relevant to the issues in this proceeding. Opposition at 3-6.

E. Reasons For Denial Of Respondent's Requests

While the Hearing Officer has authority pursuant to FINRA Rule 9251(a)(3) to expand the scope of document production beyond what is required by Rule 9251(a)(1), the Hearing Officer's authority is circumscribed by other FINRA Rules and considerations of purpose, fairness and efficiency in the conduct of this proceeding. FINRA Rule 9235 grants the Hearing Officer "authority to do all things necessary and appropriate" in the conduct of a disciplinary proceeding. This includes authority under Rule 9235(a)(4) to resolve a discovery request "subject to any limitations set forth elsewhere in the Code." With respect to evidence generally, relevance is the guiding principle in disciplinary proceedings such as this. Under FINRA Rule 9263, a Hearing Officer shall receive relevant evidence but may exclude evidence that is "irrelevant, immaterial, unduly repetitious, or unduly prejudicial."

The Hearing Officer finds it is neither necessary nor appropriate within the meaning of FINRA Rule 9135 to permit Respondent to issue its document requests.

First, as Respondent makes abundantly clear in its Motion, this disciplinary case revolves around *interpretation* of FINRA Rules regarding arbitration and class actions. In the first paragraph of its argument on the Motion, in which it describes the underlying disciplinary proceeding, Respondent uses the word interpretation four times. Motion at 1-2. It begins by

saying, "This case is about Enforcement's unprecedented *interpretation* of its rules to discipline [the Firm]." Motion at 1 (emphasis added). Then Respondent asserts that the proceeding involves questions relating to the history of the interpretation, whether the interpretation is reasonable, and whether the interpretation has been expressed in internal communications or communications with member firms. Motion at 2. The validity of an interpretation of FINRA Rules is a legal issue, not a factual issue. It depends upon whether the interpretation is reasonable in light of the text and the legislative history of the relevant Rules. Fact discovery regarding what anyone at FINRA or the SEC or anyone else has ever said at any time about the Arbitration Rules is neither relevant nor necessary.

Second, to the extent Respondent intends to argue as an affirmative defense that Enforcement's disciplinary proceeding against the Firm is unfair or a violation of due process because FINRA allegedly failed to give fair and reasonable notice of its interpretation, FINRA's internal discussions and communications are irrelevant. Furthermore, as Enforcement noted in its Opposition, internal memoranda and notes concerning the interpretation of a rule are generally not discoverable under FINRA Rule 9251(b). Opposition at 4 (citing OHO Order 08-01 (2005003437102).

Third, to the extent that Respondent seeks "legislative history" to argue that FINRA's disciplinary proceeding is based on an "unprecedented" interpretation of FINRA's arbitration Rules, Respondent does not need discovery from Enforcement. Legislative history is available in the public record of comments on the arbitration Rules and SEC and FINRA statements made in the process of proposing and adopting those Rules. As Enforcement noted in its Opposition, internal communications relating to the adoption, application, and enforcement of rules are not part of a rule's legislative history and therefore are irrelevant and inadmissible. Opposition at 5

(citing OHO Order 07-29 (2005001919501)). As Enforcement also noted, the proper interpretation of FINRA's Rules "will be determined by the language of the rules, publicly available interpretations, legislative history, and applicable legal argument." *Id.*

Fourth, Respondent's requests are overbroad and inappropriate. They are unlimited as to time and potentially encompass communications between thousands of persons, including communications among FINRA staff and communications with FINRA member firms, SEC staff, and the public. Respondent's requests also are written in the broadest terms as to subject matter. For example, *Request No. 6* asks for "[a]ll documents generated within NASD or FINRA, which inform any of their officers, investigators, auditors or other employees that the meaning, intent, or purpose of the Rules" is to bar customer class action waivers. It is unclear what the word "generates" means, but the request is so broad as to potentially encompass every piece of paper or electronic mail distributed to any FINRA employee on the subject of arbitration and class actions. Respondent's requests are not focused on *relevant* evidence and are inconsistent with the narrowly focused discovery contemplated by FINRA's procedural Rules.

Fifth, if permitted, the overbroad scope of Respondent's requests would likely delay this proceeding for a long time. Respondent seeks to serve on Enforcement requests for documents "in your possession, custody, or control." Motion, Definition in attached requests. Although "your possession" might refer to Enforcement only, the requests seek the kinds of documents more naturally found throughout FINRA, and especially in offices involved in the rulemaking process for FINRA arbitration Rules. In either event, the requests would require lengthy and expensive research to locate and identify responsive documents involved in the long and complex history of the proposal, adoption, and implementation of the Rules in issue. Such efforts would contribute little to resolution of the issues at hand, and the delay would not well-

serve the investing public. Both the Firm and its millions of customers are better served by proceeding to resolve the issues expeditiously.

Sixth, individual requests are objectionable and improper on other separate grounds that will not all be recited here. For example, *Request No. 3* seeks all documents that constitute or "show" any "actual or threatened disciplinary action" by FINRA on the subject of a class action waiver. As Enforcement points out, such documents are protected from discovery under FINRA Rule 9251(b). Opposition at 4. Respondent has presented no reason why it is necessary or appropriate to invade the privacy of other member firms and associated persons pursuant to this document request.

Respondent's authorities do not support a different result. None of them involve discovery issues or FINRA Rule 9251.

E. Conclusion

The Hearing Officer **DENIES** Respondent's Motion and declines to permit the issuance of document requests beyond the scope of document production required under FINRA Rule 9251(a)(1).

SO ORDERED.

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Lucinda O. McConathy
Hearing Officer

April 5, 2012