Securities Law Arbitration:

CONFIDENTIALITY AND THE DOCTRINE OF "SHARED DISCOVERY" IN THE ARBITRATION OF CUSTOMER CLAIMS AGAINST BROKER-DEALERS

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THE DOCTRINE OF "SHARED DISCOVERY," which permits litigants to share otherwise confidential documents produced in discovery by a common adversary, is a well-established rule of procedure in this state. In the context of securities arbitration, however, broker-dealers facing similar customer complaints often deny the applicability of this doctrine, and even the general premise that judicial proceedings should be open to public scrutiny. If accepted, such a procedural rule would significantly limit the ability of customers to efficiently and effectively prepare claims based on wide-spread misconduct, such as the conflicts of interest exposed by recent investigations into firms' recommendations of the stocks of their investment banking clients. This article explores whether efforts to construct such roadblocks to effective discovery, or to cloak the process with a veil of secrecy, further any legitimate goals of securities arbitrations.

Introduction

Virtually every claim between securities broker-dealers and their individual customers are subject to mandatory arbitration as a result of the industry standards of pre-dispute arbitration provisions in their form account opening agreements. Such arbitration clauses are enforced to compel every type of complaint about broker-dealer misconduct—whether asserted under the common law of fraud and breach of contract, or pursuant to the private rights granted under the anti-fraud and registration provisions of the state and federal securities acts—to arbitrations governed by procedures largely crafted by the securities industry itself.[1]

The vast majority of these arbitrations are administered by the National Association of Securities Dealers (NASD). In 2002, the NASD received 7,704 arbitration claims, and the filing rate through August of 2003 reflects a 23% increase over the same period of the previous year.[2] Another 1,315 claims were filed last year with the arbitration forum administered by the New York Stock Exchange ("NYSE").[3] Hence, an entire body of law and procedure, for a large class of disputes concerning the conduct of a nation-wide industry, is decided by this private corporate judicial system administered by the industry's own trade associations.

Unlike ordinary court cases, these pro-ceedings occur largely behind closed doors. A party investigating a broker or firm cannot look at the NASD or NYSE's docket to examine pleadings filed in related arbitrations and the arbitration hearings themselves are not held in public forums open to scrutiny. In addition to such secrecy, the industry respondents in these matters routinely ask arbitration panels to enter blanket confidentiality orders to limit the distribution of information about the process. Some broker-dealers do not, however, simply seek to limit access of the press. Rather, they further seek to prevent customers' counsel from using the discovery products from a given arbitration in other arbitrations against the firm, or from sharing such documents with other customer-claimants and counsel —even if those other customers have cases involving the same broker, the same investments, the same fact pattern, and the same legal claims.

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In the Texas judicial system, courts generally have no discretion to prohibit the sharing of documents or other matters simply because the press or other parties might discover it. Open scrutiny of the judicial process is considered a vital shield to corruption and an important means of assuring the public's confidence in the enforcement of the laws of our society. Even when truly confidential information is at stake—such as legitimate trade secrets—the doctrine of

"shared discovery" typically dictates that parties who obtain confidential information in one suit against a defendant may share that information for use in other suits, so long as the party receiving that information agrees not to disclose it to the defendants' competitors.

Both of these premises, considered so fundamental to the efficient and honest functioning of the judicial process in almost every state and federal court, are equally compelling in the context of industry-sponsored securities arbitrations. Unfortunately, the rules governing securities arbitration do not address the permissible scope or use of protective orders. As a result, arbitrators have scant guidance from prior decisions because (a) arbitrators are trained to avoid disclosing the reasons for their actions, and (b) the lack of meaningful appellate review of arbitration decisions has the collateral effect that no developing body of precedent guides future panels on procedural or substantive questions. Accordingly, like most other procedural and substantive issues in the realm of broker-dealer liability, requests for confidentiality present battles that practitioners in this field can expect to fight over and over again until the SEC mandates written arbitration rules limiting the use of global confidentiality orders.

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Discovery in Securities Arbitration – An Overview

Documents are generally the beginning and end of meaningful discovery in securities arbitrations. Depositions are rarely permitted, and standard interrogatories are expressly discouraged. Documents, on the other hand, abound. Broker-dealers are required, by extensive federal regulations and rules of the NASD and NYSE, to maintain detailed records of almost every aspect of their dealings with customers and employees.[4] Firms are required to maintain written supervisory procedures (generically referred to as "compliance manuals") describing the steps that they agree to undertake to ensure compliance with regulatory obligations and to "detect and prevent" violations of securities laws. They are required to record the fact of, and basis for, the recommendations they make to customers; they are required to review and maintain copies of all pertinent communications, including e-mails; they are required to document their reviews of accounts that reflect unusual or unwise activity; they are required to keep records of their internal audits (conducted at least annually) of the operations of every branch office. These documents can paint a vivid picture of the dealings between a customer, the "financial advisor," and his firm.

Accordingly, attorneys repre-senting customers request the same categories of documents in connection with every "routine" customer claim, such as those for churning, unsuitability, unauthorized trading, failure to supervise, and other fraudulent conduct.[5] Recognizing this, in 1999 the NASD promulgated Notice to Members 99-90, commonly referred to as the "Discovery Guide."[6] This guidance includes a series of document lists that parties are expected to exchange "without arbitrator or staff intervention," and states that the documents on these lists are considered "presumptively discoverable" absent a showing of "good cause not to order production." In addition to account statements, agreements, confirmations, and customer communications, these lists call for the production of documents such as compliance manuals, exception reports, branch audits, disciplinary records, the basis for recommendations, commission runs and other documents reflecting compensation received by the firm or broker.

The NASD promulgated the Discovery Guide to reduce discovery delays, based on its stated observation that: "Discovery disputes have become more numerous and more time consuming. The same discovery issues repeatedly arise." Unfortunately, the Discovery Guide has not lived up to its promise. Respondent firms routinely refuse to produce "presumptively discoverable" documents, forcing claimants to file and argue motions asking arbitration panels to compel the firm to produce documents listed in the Discovery Guide.[7]

A tactic that some firms employ to delay production of these documents is an insistence, prior to production, upon a "confidentiality" agreement or order barring the claimants from retaining discovery products after completion of the matter, or from sharing these materials with other parties. Brokerage firms typically argue that such confidentiality orders are necessary to (1) protect their trade secrets; (2)

prevent the press from reporting on the matters at issue; and (3) protect themselves from future litigation.

Arbitrators are given no written guidance by their sponsoring forums for responding to such requests. The NASD's Code of Arbitration Procedure is silent on the issue. The Discovery Guide obliquely states:

> If a party objects to document production on grounds of privacy or confidentiality, the arbitrator(s) or one of the parties may suggest a stipulation between the parties that the document(s) in question will not be disclosed or used in any manner outside of the arbitration of the particular case, or the arbitrator(s) may issue a confidentiality order.

Nothing in the rules or guidance, however, suggests which documents might qualify for such broad secrecy, or the standards that an arbitrator should apply to make this determination.

On the other hand, the NASD and NYSE have, through their congressional testimony and conduct relating to their organizations' investigation of widespread analyst fraud, acknowledged the importance of shared discovery in exposing the truth and in permitting arbitration to serve its purported goals of equity and efficiency. Specifically, after exposing the pattern of compromised and outright fraudulent "research" recommendations issued by some firms, every regulator involved disclosed key evidence of the schemes for public view. The head of the NASD then explicitly stated his expectation that the documents so exposed will be used in arbitrations by, and lead to further discovery by, the thousands of retail investors who suffered losses after relying on their broker-dealers for honest stock recommendations.

Openness and the Shared Discovery Doctrine: The Legal Framework

When arbitrators look to case law for guidance, they find clear authority condemning broad confidentiality orders. The courts of every jurisdiction in this country view unwarranted requests for secrecy with extreme disdain. The widely-accepted "shared discovery" doctrine protects the rights of individuals to share the fruits of discovery produced by repeat defendants.

As a general principle, there is a reason that the term "star chamber" is derogatory. The courts of every jurisdiction in this land recognize that secrecy for its own sake generally protects nothing but corruption, falsehoods, and inequity. A presumption of openness applies to all court proceedings in this country, criminal and civil, because "secrecy insulates the participants, masking impropriety, obscuring incompetence, and concealing corruption."[8] The U.S. Supreme Court held that this presumption of openness "may be overcome only by an overriding interest based on findings that closure [of proceedings from public scrutiny] is essential to preserve higher values."[9]

The Ninth Circuit recently held that this same policy applies to arbitrations, and that attempts to make consumer arbitration proceedings confidential are void as an unconscionable violation of public policy.[10] The court reasoned that "confidentiality provisions usually favor companies over individuals," and fairness requires openness so that claimants will have access to the same body of knowledge and experience that the "repeat player" corporation gains from multiple arbitrations.

Even when evidence is entitled to be kept confidential because it contains trade secrets or other sensitive information, the doctrine of shared discovery dictates that a plaintiff who obtains documents from a defendant in one case is generally permitted to share those documents with a similarly situated plaintiff who is adverse to the same defendant. The party with whom the discovery is shared is, of course, prohibited from disseminating trade secrets to competitors of the producing party, and the producing party is typically entitled to the names of all such parties with whom information was shared. Subject to these caveats, however, even truly confidential information is free for use in other litigation against the producing party.

In Texas, courts generally have no discretion to prohibit the sharing of discovery products. At least two goals justify this doctrine: (1) full disclosure of the truth; and (2) efficiency. As the Texas Supreme Court observed in *Garcia v. Peeples*:

> Shared discovery is an effective means to insure full and fair disclosure. Parties subject to a number of suits concerning the same subject matter are forced to be consistent in their responses by the knowledge that their opponents can compare those responses.
>
> In addition to making discovery more truthful, shared discovery makes the system itself more efficient. [Without it, the system] forces similarly situated parties to go through the same discovery process time and time again, even though the issues involved are virtually identical. [11]

The court further noted that both state and federal courts across the country have adopted this doctrine to help streamline discovery, reduce costs for parties seeking it, and improve judicial economy.[12] The alternative offers nothing but waste and expense, as "one party facing a number of adversaries can require his opponents to duplicate another's discovery efforts, even though the opponents will share similar discovery needs and litigate similar issues."[13] Accordingly, shared discovery is the controlling premise in virtually every jurisdiction that has considered the issue.[14]

Application of the Shared Discovery Doctrine to Securities Arbitrations

The core justifications for the shared discovery doctrine apply squarely to the vast majority of garden-variety securities arbitrations. Regrettably, the *Peeples* court described an alternative which fairly portrays the state of discovery in securities arbitration today:

> [T]he ultimate purpose of discovery is to seek the truth, so that disputes may be decided by what facts reveal, not by what facts are concealed. Unfortunately, this goal of the discovery process is often frustrated … The "rules of the game" encourage parties to hinder opponents by forcing them to utilize repetitive and expensive methods to find out the facts. The truth about relevant matters is often kept submerged beneath the surface of glossy denials and formal challenges to requests until an opponent unknowingly utters some magic phrase to cause the facts to rise. Courts across the country have commented on the lack of candor during discovery in complicated litigation.[15]

A routine example of such skullduggery in securities arbitrations is the production of a firm's "compliance manual," an item that the NASD's Discovery Guide declares "presumptively discoverable" in every customer case. Some firms assert that their manuals are "trade secrets" entitled to special protections.[16] These firms would have claimants' counsel return the manuals at the conclusion of each matter, even if that counsel repeatedly represents customers against that firm and would be required thereby to repeatedly fight for possession of the same documents that he used in the last case.

Inefficiency, however, is the lesser of the evils promoted by this game. More than one brokerage firm, for example, has been known to claim in discovery that it has only one "compliance manual," when in fact its supervisory procedures are spread through a variety of additional documents with names like "Compliance Department Procedure Manual," "Account Executive Compliance Manual," and "Branch Manager's Operations Manual." Or a firm will produce the 1995 version of a manual, when in fact a 1997 revision was the operative document. Without shared information about these documents, the unwary practitioner would never know that the cloak of confidentiality has been used to conceal the truth.

Supervisory procedures are not the only documents for which shared discovery is a practical necessity, because it is not unusual for a firm's conduct in a particular circumstance to generate multiple claims. A broker or firm intent on committing fraud will rarely focus their efforts on just one customer. There are countless examples of individual brokers whose activities have spawned several, and even dozens or hundreds of claims. Each of those customers will need discovery of all of the firm's communications with that broker, his employment file, his trade-by-trade compensation, his exception reports and audits, and every other document pertaining to (or failing to pertain to) the scheme at issue. No system intent on exposing the truth and promoting equitable results would permit the firm to force every customer to go through the same discovery battles in one matter to obtain documents that the firm had already been ordered to produce in another.

The importance of the shared discovery doctrine is particularly highlighted by the mounting wave of customer arbitrations being filed in response to the exposure of the widespread fraud that culminated in the April 2003 conflict-of-interest "Global Settlement" between most of the major Wall Street brokerage firms and the SEC, NASD, NYSE, and various state regulators. The Global Settlement investigations revealed that analysts at many brokerage firms placed "buy" ratings on the securities of their employers' investment banking clients, while privately those same analysts admitted (often in casual e-mails) that those ratings were a direct result of the investment-banking relationship, and that the recommendations were without merit or outright false.

In exposing these systematic misrepresentations, all of the various regulators acknowledged the importance of shared discovery by publicly disclosing some of the most damaging documents. The regulators expressly refused firms' requests for confidential treatment of those documents. In addition to excerpts from the firms' relevant compliance manuals, these "smoking guns" included numerous categories of documents that the firms claimed were confidential, such as personnel reviews, sales pitches, and internal profitability reports.

Copies of many of these are now available to the public on the web pages of various regulators.

In Senate testimony earlier this year, NASD Chairman Robert Glauber encouraged defrauded investors to use these published documents as a "roadmap" for their actions against particular firms. He stated that the NASD is "hopeful" that these documents "make it easier for investors to recover their losses through arbitration … as evidence from the settlement can be used to make the case for recovery of investor losses."[17] In light of this testimony, it appears that Mr. Glauber would strongly disagree with the assertion of NASD member firms that his arbitration forum should participate in efforts to obstruct shared discovery of additional evidence in these cases.

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Mr. Glauber's testimony reflects a recognition that the NASD and NYSE cannot permit their arbitrators to impose blanket secrecy orders over the products of discovery from their forums, without grave consequences for the public's confidence in industry-sponsored arbitration and the securities markets that the NASD and NYSE are required to regulate. Even Senator Jon Corzine, former Chairman of Wall Street powerhouse Goldman Sachs, Inc., has questioned the ability of industry-controlled arbitration fora to fairly and transparently decide claims based on such wide-spread conduct. In questioning SEC Chairman William Donaldson about the Global Settlement, Senator Corzine observed:

> This arbitration process is going to be very much one of those areas where the public is going to look for the fairness that will be tied to whether there is a restoration of public confidence in the process. If it is not one that is both transparent, fair minded for those that participate, if they feel like the process doesn't come out, in aggregate, with fair response to investors' complaints, I think we will not have had all the benefits that were intended by the efforts of the global settlement.[18]

Senator Corzine echoed the principle of openness that has, for ages, governed the conduct of every other judicial forum in this country. At a time when Wall Street has systematically undermined the confidence of individual investors in the lawful functioning of our securities markets, this need for transparency—for open proceedings that expose for scrutiny the alleged efficiency and fairness of the private judicial systems administered by the NASD and NYSE—is more apparent now than ever.

Conclusion

Broker-dealer requests for secrecy, and objections to shared discovery, enjoy no support in reason or jurisprudence. These requests, if honored, will foster nothing but concealment of the truth and needless increases in the cost and burden of discovery. The heads of the NASD and NYSE have both expressly and, through their actions in publishing documents as "roadmaps" to investor claims arising from analyst fraud, implicitly rejected their member firms' ad hoc proposal for rules permitting them to conceal their conduct. Until the NASD and NYSE explicitly incorporate this concept into their official rules of procedure, however, practitioners will be required to repeatedly remind arbitrators that they cannot, consistent with this "roadmap" concept and decades-old state and federal practice, prohibit individual customers from sharing information about their claims with the public, or from sharing the documents pertaining to those claims with other customers.

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[1] *See Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987).

[2] *See* "NASD Dispute Resolution Statistics," at http://ww.nasdadr.com/statistics.asp.

[3] *See* http://www.nyse.com/pdfs/arbstats090503.pdf .

[4] *See, e.g.*, SEC Rules 17a-3 and 17a-4, promulgated under the

Securities Exchange Act of 1934. 17 C.F.R. §§ 240.17a≠-3 and 240.17≠a-4 (2003).

[5] Likewise, Respondent firms will ask the customer-claimants to produce a list of "standard" items. Since customers are not generally the type of repeat litigants whose personal documents might be relevant in other disputes, however, their document productions do not raise the type of "shared discovery" issues addressed in this article.

[6] NASD Discovery Guide, printed in NASD Notice to Members 99-90 (November 1999), at http://www.nasdr.com/pdf-text/9990ntm.com.

[7] Firms engage in such conduct with apparently little fear of consequence, due to the structural deficiencies inherent in any arbitration forum that routinely serves a single industry in its disputes with individual claimants, a circumstance which makes it impossible for arbitrators to hold the industry fully accountable if they wish to obtain future appointments. A full discussion of the evils of such a system is far beyond the scope of this article.

[8] *Brown & Williamson Tobacco Corp. v. FTC*, 710 F.2d 1165, 1179 (6th Cir. 1983), quoted in *Kelli Sager & Matthew Leish, In Defense of Public Trials*, 29 LITIGATION 54, 58 (2003).

[9] *Press-Enterprise v. Superior Court*, *464 U.S. 501, 510 (1984).*

[10] *Ting v. AT&T*, 319 F.3d 1126, 1151-52 (9th Cir.), *cert denied*, 2003 U.S. Lexis 5506 (2003).

[11] 734 S.W.2d 343, 347 (Tex. 1987) (multiple citations omitted).

[12] *Id.* (citing *Wilk v. American Medical Ass'n*, 635 F.2d 1295, 1299 (7th Cir. 1980); *American Telephone and Telegraph Co. v. Grady*, 594 F.2d 594, 597 (7th Cir. 1979); *Phillips Petroleum Co. v. Pickens*, 105 F.R.D. 545, 551 (N.D. Tex. 1985); *Ward v. Ford Motor Co.*, 93 F.R.D. 579, 580 (D. Colo. 1982); *Carter-Wallace v. Hartz Mountain Industries*, 92 F.R.D. 67, 70 (S.D.N.Y. 1981); *Patterson v. Ford Motor Co.*, 85 F.R.D. 152, 154 (W.D. Tex. 1980); *Parsons v. General Motors Corp.*, 85 F.R.D. 724, 726 (N.D. Ga. 1980)). Moreover, the *Garcia* court also observed that the Federal Judicial Center's Manual for Complex Litigation recommends sharing discovery in order to avoid duplicate efforts. *Id.* (citing *Manual for Complex Litigation*, Pt. I, § 3.11 (5th ed. 1982)).

[13] *Id.*

[14] *See Wolhar v. General Motors Corp.*, 172 A.2d. 464, 467 & n.8 (Del. Super. Ct. 1997) ("The great weight of authority in other jurisdictions holds that such sharing is not only theoretically sound but also justified as an efficient use of the resources of the courts and parties.").

[15] 734 S.W.2d at 347.

[16] This claim is dubious because the contents of the manuals are required by federal law. Numerous arbitration panels, and the only two courts known to have addressed the issue, have determined that compliance manuals are not confidential trade secrets. *See Miller v. Smith, Barney, Harris Upham*, 85-86 *Fed. Sec. L. Rep.* ¶ 92,498 (S.D.N.Y. 1986); *Galucci v. Fleet Nat'l Bank*, Case No. PC02-6837, Sup. Ct. of R.I. (Order of July 16, 2003) (unpublished).

[17] *See* "Investment Banking Practices," May 7, 2003 Hearing Before the Senate Committee on Banking, Housing, and Urban Affairs (Chairman Richard Shelby, R-Alabama). Chairman Glauber further testified that: "We are gearing up for a large arbitration load. We believe there will be a lot of actions brought, as there should be." http://banking.senate.gov/03_05hrg/050703/live.ram [time 2:47:35-:57; 3:39:52-:08].

[18] http://banking.senate.gov/03_05hrg/050703/live.ram [time 1:47:20 – 1:48:00].