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Forced Arbitration - Perfect Justice? Discovery in Arbitration

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ed: Part of SAC's emphasis in the coming year will be to focus more on the concerns and experiences of practitioners and other participants in the securities arbitration process. Arbitration's informal nature inhibits the compilation of "hard" information about the workings of the mechanism. By experiential examples and the presentation of various perspectives from guest writers, we hope to give the picture some definition and dimension.

The discovery process, especially the way it works in practice, is one of the more elusive elements of the arbitral mechanism. Whether the parties to a particular dispute get the information they need in discovery will probably remain more dependent upon chemistry and good will than it will upon hard-and-fast procedures. Still, the new discovery rules attempt to impose some structure upon the parties and have now been in place for more than a year.

Our guest writers undertook their own "horseback" survey to discover what criticisms are most frequently heard and what suggestions there might be for improvement.

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Arbitration of securities disputes was seen historically as a quick, cost effective, and efficient alternative to the court system. Now that arbitration is no longer an alternative, but rather the only option for many, claimants and plaintiff's attorneys are asking that arbitrations be more "fair," especially in the area of document production in discovery.[1]

We spoke with over 40 individuals in the securities field nationwide who regularly serve as either plaintiff or defense attorneys in securities cases or who are arbitrators for the National Association of Securities Dealers (NASD), the New York Stock Exchange (NYSE), or the American Arbitration Association (AAA). When we polled plaintiff's attorneys and arbitrators on how they felt discovery in arbitration was working, the overwhelming response was that the system needed overhauling. We heard comments such as "Discovery in arbitration is an abomination and only slightly better than adjudication by ambush" and "With the present state of discovery, securities arbitrations are 'rough justice,' at best.[2]"

cont'd on page 2

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DISCOVERY REVIEW *cont'd from page 1*

Everyone agrees that formal discovery procedures in arbitration were nonexistent two years ago. Now the arbitration rules of the NYSE, the NASD, and the AAA provide for limited discovery. In our opinion, the arbitration system must change in order to better strike the proper balance between document production and expeditiously resolving disputes.

Brokerage firms strongly favor forced arbitration, as well they should. In arbitration, brokerage firms are shielded from sympathetic juries and runaway awards of punitive damages and attorney fees are rarely found. Brokerage firms are the ones that generally have reason to fight to limit discovery. They benefit from limited discovery because as defendants, they usually possess the very documents that the plaintiff needs to prove his or her case. Since the burden of proof is on the plaintiff, the less information the plaintiff has, the easier it is to defend the claims.

It is not surprising then that virtually all of the criticism of discovery in arbitration that we encountered in our poll came from plaintiffs' counsel. This fact may establish a negative tilt to this article, but our intention is to expose these critical observations for discussion and to further efforts to improve the discovery process.

Naive Rules. The problems with discovery in arbitration are multifold; however, at the source lies the ineffectiveness of the following single rule which, until recently was the only rule on prehearing discovery:

> The parties shall cooperate to the fullest extent practicable in the voluntary exchange of documents and information to expedite the arbitration.[3]

The rule is naive in that it presupposes that parties and their attorneys will voluntarily turn over documents which will hurt them when there is no threat of sanction over refusal. As one defense attorney aptly put it, "It is my job to object to every request for production and force the other side to overcome my objections." Objections that requests are burdensome, irrelevant, privileged, overbroad and vague are used regularly.

In 1989, the NASD and the NYSE responded to complaints about discovery by amending their rules to provide a timetable for parties to respond to information requests.[4] More importantly, however, was the creation of the prehearing conference. The NASD and NYSE rules now provide that parties who are unsatisfied with responses to their information requests can request a prehearing conference before a "presiding person," who generally has been one of the arbitrators or the entire panel. Parties are entitled to a prehearing conference as a matter of right under the language of the rule. The AAA system has always provided for a prehearing conference; however, the hearing is not a matter of right and it is not specifically designed to resolve discovery disputes.[5]

The NYSE and NASD rule providing for prehearing conferences may be causing more problems with discovery than it is solving. The intent of the rule was that parties would more readily comply with discovery requests or resolve their disputes themselves if the parties knew that they would be forced to a prehearing conference to resolve their differences. We talked to many attorneys who indicated that just the opposite was happening. We hear of parties making no attempt to cooperate, thus forcing the use of prehearing conferences on a more frequent basis.

The problem is not just with brokerage firms refusing to produce documents. Claimants and their attorneys contribute to the abuse by using discovery requests as fishing expeditions to obtain virtually every category of document conceivable in an effort to build their case on what they find. One staff member at the NYSE told us that prehearing conferences are often screaming matches where little is accomplished. The routine requesting of prehearing conferences may result in a rule change, making prehearing conferences discretionary with the panel rather than mandatory.

Panel Selection. The one complaint voiced by all attorneys in our poll was that the arbitration panel is not chosen until very late in the process; therefore when disputes arise, no one is available to hear and resolve the problems. Why are the panels chosen so late? Staff members at the NYSE and the NASD gave us no answers and many attorneys with whom we spoke responded when asked, "That's the million dollar question."

The earlier the selection process is begun, the earlier the arbitration panel is finalized. An arbitration panel is not finalized until the parties have exercised their right to challenge appointed arbitrators. The late striking of arbitrators appointed under the NASD and NYSE systems further compounds the problem of the lack of arbitrators to preside over the prehearing conference. Under the AAA system, the selection and striking process is initiated almost immediately after the complaint is filed, thereby better ensuring the availability of arbitrators.

When prehearing conferences are held, they are often so close to the arbitration hearing date that when the arbitrator directs the brokerage firm to turn over documents to the claimant, one of two things usually happens. Either the brokerage firm complies and there is insufficient time for the claimant to prepare for the arbitration hearing or the brokerage firm fails to fully comply and the claimant has no remedy prior to the arbitration hearing.

We learned about situations where at the start of the arbitration hearing, the claimant and his or her attorney complained that they still did not have the documents the arbitrator said they were entitled to have and the hearing proceeded without even a slap on the proverbial hand of the brokerage firm. We wonder if, at times, justice is sacrificed in the name of expediency.

cont'd on page 3

DISCOVERY REVIEW *cont'd from page 2*

An additional quandary in the area of panel selection is that good arbitrators are needed for large, complex cases, but those cases often require as much as a week's time to arbitrate and the very people needed to serve cannot afford the time. The result is that retiree arbitrators serve on the big cases and the more qualified professionals serve on the small cases. In our opinion, arbitrators should be paid more than the now required $225.00 a day, in order to attract well qualified individuals.

No Teeth. The present arbitration rules have no teeth. They scarcely address the arbitrator's authority, except to say that the arbitrators have subpoena power over witnesses and documents and that the arbitrators can exclude documents and witnesses which have not been revealed at least 10 days before the arbitration hearing.[6]

We heard time and time again that arbitrators are reluctant to enter sanctions against brokerage firms. Staff members of the NASD told us that the only practical sanction arbitrators have available at this time is to assess the cost of the prehearing conference against the uncooperative attorney and/or client, which is usually $300.00. A multibillion dollar company may well reason that incurring a $300.00 fine for refusing to produce documents that if produced could result in damages of 1,000 times the fine is a good business decision.

Clearly, arbitrations are not courts of law. The claimant agreed to the following condition when he signed the brokerage firm's account papers:

> Pre-arbitration discovery is generally more limited than and different from court proceedings.[7]

The danger is that such a policy statement encourages brokerage firms to hold back production of documents the claimant is entitled to use in the presentment of his or her claim.

Let's take the example of the claimant who cannot extract from the brokerage firm trades done in the broker-in-question's other accounts. The brokerage firm argues that such information is not relevant to what happened in the claimant's particular case, that the request is overly burdensome, and that the request violates the confidence of the firm's clients.

When and if a prehearing conference is held, there is no guarantee that the arbitrator will order the brokerage firm to produce documents requested or sanction the brokerage firm for failing to produce them. The claimant suffers from the system that, innocently or not, precludes the prehearing conference and/or fails to address a party's "noncooperation."

Suggestions. The system needs teeth to work. One of the first questions to ask at a prehearing conference should be, "why was it necessary to have this hearing?" The parties should be required to prove at the prehearing conference that they attempted to work out their differences.[8] Such a procedure will force parties to clean up their acts and lessen the need for prehearing conferences.

The SRO's might consider mandatory sanctions or more specific guidelines for certain abuses; for example, if a brokerage firm continues to refuse to turn over documents after being ordered to do so by the arbitration panel, the brokerage firm could be sanctioned by requiring the arbitrators to accept as fact that which the claimant is attempting to show through production of those documents. When assessing monetary sanctions, the arbitrators should consider the wealth of the violator and past instances of resisting discovery in that particular case.

One of the most common suggestions we heard on ways to change the system was better education of arbitrators through articles and seminars regarding what is to be expected in discovery and the necessary penalties for those who do not comply. Before the education process can begin, the SRO's and the AAA must better formalize their guidelines regarding discovery. We believe this can be done without amendment of the rules.

Claimants' attorneys can benefit by more effective arguments to require production of certain documents. In our example of the brokerage firm that objects to the production of trades done in the broker-in-question's other accounts, several offensive arguments are available. Establish that the documents are relevant.[9] For example, if the claimant asserts a RICO claim, a pattern of conduct is a necessary element to the claimant's case.

Secondly, the claimant can reimburse the brokerage firm the cost of retrieving the requested information, thereby minimizing the defendant's "burden." The arbitration rules require such reimbursement.[10] Lastly, the claimant can either enter into a nondisclosure agreement to protect the confidentiality of the firm's customers or stipulate that account numbers will suffice in the place of names and addresses.

Claimants should service their requests for production and other discovery as soon as possible and be very specific in their requests. Claimants will develop a better working relationship with opposing attorneys if they serve discovery that does not appear to be fishing expeditions. If the claimant has a particular document in mind and can find a similar version, attach it to the request in order to elicit responses in the same format.

Claimants may prevent objections to discovery requests by listing their reasons for discovery of particular information. Claimants may be showing their hand a bit, but they will have to anyway at a prehearing conference. If the claimants fail to obtain the re-

cont'd on page 4

DISCOVERY REVIEW *cont'd from page 3*

quested documents, one of those rare occasions may be created where depositions or interrogatories are appropriate to prove up the information in those documents.

If claimants or brokerage firms find themselves in an arbitration without documents they have requested, they should not hesitate to draw inferences to the arbitrators that documents are being unreasonably withheld by the opposition. Section 17 of the Securities Exchange Act of 1934 requires brokerage firms to maintain records. Therefore, a brokerage firm's response that it does not have the documents should always be tested against the applicable retention requirements of SEC Rule 17a-4.

Attorneys for their respective clients should meet discovery request response deadlines and if a timely response is not received, they should call the opposing counsel. If it is obvious that their requests are not going to be met, the noncompliance should be documented and a prehearing conference should be requested as soon as possible. The diligent attorneys who follow up on not only their discovery requests, but their request for a preliminary conference will be well-rewarded.

Anyone who has been a part of securities arbitration knows the feeling of reinventing the wheel with every discovery dispute and with each new arbitration panel. We applaud the SRO's 1989 revisions to discovery procedure; however, it is now time for the SRO's and the AAA to address those complaints voiced by so many in our poll.

Footnotes

[1] The United States Supreme Court sanctioned forced arbitrations of securities disputes in Shearson/American Express, Inc., v. McMahon 482 U.S. 220 (1987).

[2] Discovery problems are not unique to arbitration. The October, 1990 ABA Journal Article reported that in the court system, 50% of the attorneys felt the discovery process was inefficient.

[3] NYSE Arbitration Rule 619(a) (1989); NASD Code of Arbitration Procedure, Section 32. There is no corollary rule under the AAA Securities Arbitration Rules; however, Rule 10 allows for a preliminary hearing to address "the extent and schedule for the production of relevant documents and other information."

[4] A party may serve an information request 20 days or more after the claim is filed or defendant has answered, whichever is earlier. A party has 30 days within which to object or answer the request and the opposing side has 10 days within which to respond to objections. NYSE Arbitration Rule 619 (b); NASD Code of Arbitration Procedure, Section 32 (b).

[5] AAA Securities Arbitration Rule 10.

[6] NASD Code of Arbitration Procedure, Sections 32(c) and 33; NYSE Arbitration Rules 619(c) & (f). AAA's Securities Arbitration Rules do not provide for the exchange of evidence prior to the arbitration hearing; only that the arbitrator may subpoena witnesses and documents. Rule 31.

[7] This provision was made part of the requirements for predispute arbitration agreements, which went into effect September 7, 1989 for all members of self regulatory organizations (SRO's).

[8] The SRO discovery rules require that "the parties shall endeavor to resolve disputes regarding an information request prior to serving any objections to the request. Such efforts shall be set forth in the objections." See, e.g., Section 32(b)(1) of the NASD Rules.

[9] Rule 619(a) of the NYSE Rules and Section 32 of the NASD Rules state that "Any request for documents or other information should. . . relate to the matter in controversy. . . ." "Relevant evidence" is defined by Rule 401 of the Federal Rules of Civil Procedure as "evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence."

[10] Rule 619(g) of the NYSE Rules and Section 33(b) of the NASD Rules.

Letters to Editor:

ed.: Subscribers have been reacting to the invitation extended by the Public Members of SICA (See 3 SAC 9(19) and 3 SAC 10(3)) and by SAC to comment upon current proposals and to report your experiences in arbitration. Letters to SAC will not always get a response from us, but we do pass the letters on to SICA members and may use portions for publication or background in the newsletter.

Of course, our simple format will not permit reprints of the letters received in most cases; but, in this instance, the excerpts from Mr. Bernstein's letter below complemented the subject matter of our lead article and was, at the same time, one of the first and most thoughtful of the response letters we have received. We hope readers will continue to "Make the Connection" with SICA.

Dear Editor:

Per your note on page 3 of the October 1990 issue of The Commentator, I have several comments concerning recent SICA Proposals.

1. Attorney-Client Privilege. The attorney-client privilege is one of the most fundamental rights that a party to litigation may have. In the past year, I have been involved in several arbitration proceedings in which questions have arisen concerning whether communications qualified for the privilege. In certain instances, determination of privilege may be quite a complex affair, as well as are issues of waiver of privilege, etc.

Since a large percentage of arbitrators are not attorneys, they are unfamiliar with all of the intricacies of the law of evidence concerning privilege, although I have found that they are generally familiar with the fundamental rule.

cont'd on page 5