

For the Commission by the Division of Market Regulation, pursuant to delegated authority.<sup>5</sup>

**Margaret H. McFarland,**  
*Deputy Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-41302; File No. SR-NASD-99-07]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Creating a Discovery Guide for Use in NASD Arbitrations

April 16, 1999.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on January 29, 1999, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary NASD Regulation, Inc. ("NASD Regulation"), filed with the Securities and Exchange Commission ("Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD Regulation. On March 23, 1999, NASD Regulation submitted Amendment No 1 to the proposed rule change.<sup>3</sup> NASD Regulation submitted Amendment No. 2 to the proposed rule change on April 9, 1999.<sup>4</sup> The Commission is publishing this notice of the rule change, as amended, to solicit comments on the proposed rule change from interested persons.

#### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

NASD Regulation has filed with the Commission a proposed Discovery Guide for use in NASD arbitration proceedings to improve the discovery

process in NASD-sponsored securities arbitrations. Below is the text of the proposed rule change which would create the Discovery Guide and Document Production Lists.

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#### Discovery Guide

For NASD arbitrations, the Discovery Guide supplements the section in The Securities Industry Conference on Arbitration ("SICA") publication entitled "The Arbitrator's Manual," and captioned "Prehearing Conference," found on pages 11 through 16, regarding public customer cases.

##### I. The Need for New Discovery Procedures

Discovery disputes have become more numerous and time consuming. The same discovery issues repeatedly arise. To minimize discovery disruptions, the NASD Regulation Office of Dispute Resolution has developed two initiatives to standardize the discovery process: early appointment of arbitrators to conduct an initial prehearing conference and document production lists ("Document Production Lists").

No requirement under the Discovery Guide supersedes any record retention requirement of any federal or state law or regulation or any rule of a self-regulatory organization.

The Discovery Guide and Document Production Lists are designed for customer disputes with firms and Associated Person(s).<sup>5</sup> The Discovery Guide also discusses additional discovery requests, information requests, depositions, admissibility of evidence, and sanctions.

The Discovery Guide, including the Document Production Lists, will function as a guide for the parties and the arbitrators; it is not intended to remove flexibility from arbitrators or parties in a given case. For instance, arbitrators can order the production of documents not provided for by the Document Production Lists or alter the production schedule described in the Discovery Guide. Further, nothing in the Discovery Guide precludes the parties from voluntarily agreeing to an exchange of documents in a manner different from that set forth in the Discovery Guide. In fact, the Office of Dispute Resolution encourages the parties to agree to the voluntary exchange of documents and information and to stipulate to various matters. The fact that an item appears on a Document Production List does not shift the burden of establishing or defending any aspect of a claim.

##### II. Document Production Lists.

The Office of Dispute Resolution will provide the parties with Document Production Lists (attached to the Discovery Guide) at the time it serves the statement of claim in customer cases. The arbitrators and the parties should consider the documents described in Document Production Lists 1 and 2 presumptively discoverable. Absent a written objection, documents on Document Production Lists 1 and 2 shall be exchanged

by the parties within the time frames set forth below.

The arbitrators and parties also should consider the additional documents identified in Document Production Lists 3 through 14, respectively, discoverable, as indicated, for cases alleging the following causes of action: churning, failure to supervise misrepresentation/omission, negligence/breach of fiduciary duty, unauthorized trading, and unsuitability. For the general document production and for each of these causes of action, there are separate Document Production Lists for firms/Associated Person(s) and for customers.

NASD Rule 10321 provides that the parties shall cooperate to the fullest extent practicable in the voluntary exchange of documents and information to expedite the arbitration process. As noted, nothing in the Discovery Guide precludes parties from voluntarily agreeing to an exchange of documents in a manner different from that set forth in the Discovery Guide.

#### A. Time Frames for Document Production and Objections

The parties should produce all required documents listed in the applicable Document Production Lists not later than thirty days<sup>6</sup> from the date the answer is due or filed, whichever is earlier. If a party redacts any portion of a document prior to production, the redacted pages (or ranges of pages) shall be labeled "redacted." A party may object to the production of any document, which would include an objection based upon an established privilege such as the attorney-client privilege. If any party objects to the production of any document listed in the relevant Document Production Lists, the party must file written objections with the Office of Dispute Resolution and serve all parties not later than thirty days following the date the answer is due or filed, whichever is earlier. Objections should set forth the reasons the party objects to producing the documents. An objection to the production of a document or a category of documents is not an acceptable reason to delay the production of any document not covered by the objection. A response to an objection should be served on all parties within 10 days from service of the written objections. Objections and responses should be filed with the Office of Dispute Resolution at the time they are served on the parties. The arbitrator(s) shall then determine whether the objecting party has overcome the presumption based upon sufficient reason(s).

<sup>6</sup> All time periods referenced herein are calendar days.

<sup>5</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See letter from Alden S. Adkins, Senior vice President and General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, dated March 23, 1999. In Amendment No. 1, NASD Regulation made minor changes to the Discovery Guide in response to some of the Commission's concerns about the Guide ("Amendment No. 1").

<sup>4</sup> See letter from S. Alden, Senior Vice President and General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, dated April 9, 1999. In Amendment No. 2, NASD Regulation made minor changes to clarify some of the language within the Discovery Guide ("Amendment No. 2").

<sup>5</sup> NASD Regulation may develop separate Document Production Lists for intra-industry disputes.

## B. Confidentiality<sup>7</sup>

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. The arbitrator(s) shall not issue an order or use a confidentiality agreement to require parties to produce documents otherwise subject to an established privilege. Objections to the production of documents, based on an established privilege, should be raised in accordance with the time frame for objections set forth above.

## C. Affirmation in The Event That There Are No Responsive Documents or Information

If a party responds that no responsive information or documents exist, the customer or the appropriate person in the brokerage firm who has personal knowledge (i.e., the person who has conducted a physical search), upon the request of the requesting party, must: (1) State in writing that he/she conducted a good faith search for the requested information or documents; (2) describe the extent of the search; and (3) state that based on the search, no such information or documents exist.

## III. The Initial Prehearing Conference

To maximize the efficient administration of a case by the arbitration panel,<sup>8</sup> the Office of Dispute Resolution staff will schedule an initial prehearing conference in which the arbitrator(s) usually participates.<sup>9</sup> The initial prehearing conference gives the arbitrator(s) and the parties an opportunity to organize the management of the case, set a discovery cut-off

date,<sup>10</sup> identify dispositive or other potential motions, schedule hearing dates, determine whether mediation is desirable, and resolve any other preliminary issues.<sup>11</sup> During the initial prehearing conference, the arbitrator(s) and the parties should schedule hearing dates for the earliest available time, consistent with the parties' need to prepare adequately for the hearing.

Prior to the initial prehearing conference, each arbitrator should become familiar with the claims and defenses asserted in the pleadings filed by the parties. At the initial prehearing conference, the arbitrator(s) should order time limits for discovery that will allow the scheduling of hearing dates within a reasonable time and address all outstanding discovery disputes. If the exchange of properly requested documents has not occurred, the arbitrator(s) should order the production of all required documents, including those outlined in the Document Production List (see section II. above), within 30 days following the conference.

## IV. Additional Discovery Requests

The parties may request documents in addition to those identified in the Document Production Lists pursuant to Rule 10321(b). Unless a longer period is allowed by the requesting party, requests should be satisfied or objected to within 30 days from the date of service of the document request. A response to an objection should be served on all parties within 10 days from service of the written objections. Requests, objections, and responses should be filed with the Office of Dispute Resolution at the time they are served on the parties.

A party may move to compel production of documents when the adverse party (a) refuses to produce such documents or (b) offers only to produce alternative documents that are unacceptable to the requesting party. The Office of Dispute Resolution will provide the chairperson of the panel with the motion, opposition, and reply,

<sup>10</sup> The Office of Dispute Resolution recommends that the panel set a cut-off date during the initial prehearing conference for service of discovery requests, giving due consideration to time frames that permit timely resolution of objections and disputes prior to the scheduled exchange of hearing exhibits pursuant to the NASD Code of Arbitration Procedure.

<sup>11</sup> The arbitrators should direct one of the parties to prepare and forward to the Office of Dispute Resolution, within 48 hours, a written order memorializing the results of the prehearing conference, approved as to form and content by the other parties. When motions are heard at the initial prehearing conference, the panel may order the parties to submit the order with a stipulation as to form and content from all parties.

along with the underlying discovery documents the parties have attached to their pleadings. The chairperson should determine whether to decide the matter on the papers or to convene a prehearing conference (usually via telephone). In considering motions to compel, particularly where non-production is based upon an argument asserting an established privilege, such as the attorney-client privilege, the arbitrator(s) should always give consideration to the arguments set forth by both sides, particularly as to the relevancy of the documents or information. The arbitrator(s) should carefully consider such motions, regardless of whether item requested is on any of the Document Production Lists. If in doubt, the arbitrator(s) should ask the requesting party what specific documents it is trying to obtain and what it seeks to prove with the documents.

## V. Information Requests

Like requests for documents, parties may serve requests for information pursuant to Rule 10321(b). Requests for information are generally limited to identification of individuals, entities, and time periods related to the dispute; such requests should be reasonable in number and not require exhaustive answers or fact finding. Standard interrogatories, as utilized in state and federal courts, are generally not permitted in arbitration.

Unless a longer period is allowed by the requesting party, information requests should be satisfied or objected to within 30 days from the date of service of the requests. A response to an objection should be served on all parties within 10 days from service of the written objections. Requests, objections, and responses should be filed with the Office of Dispute Resolution at the time they are served on the parties.

A party may move to compel responses to requests for information that the adverse party refuses to provide. The Office of Dispute Resolution will provide the chairperson of the panel with the motion, opposition, and reply, along with the underlying discovery documents the parties have attached to their pleadings. The chairperson should determine whether to decide the matter on the papers or to convene a prehearing conference (usually via telephone).

## VI. Depositions

Depositions are strongly discouraged in arbitration. Upon request of a party, the arbitrator(s) may permit depositions, but only under very limited circumstances, such as: (1) To preserve

<sup>7</sup> Section II. B. is also applicable to additional discovery requests and information requests (see sections IV. and V.).

<sup>8</sup> The panel consists of three arbitrators in most cases. Claims between \$25,000 and \$50,000 may proceed with a single arbitrator. Claims under \$25,000 are decided by a single arbitrator, generally on the pleadings.

<sup>9</sup> In some instances, the parties may opt out of the initial prehearing conference. To opt out, parties must supply the following information to the Office of Dispute Resolution by the specified deadline:

(1) A minimum of four sets of mutually agreeable hearing dates;

(2) A discovery cut-off date;

(3) A list of all anticipated motions with the motion due dates, opposition due dates, and reply due dates provided;

(4) A minimum of four dates and times for any proposed prehearing conferences to hear motions; and

(5) A determination whether briefs will be submitted and, if so, the due date for submission.

the testimony of ill or dying witnesses; (2) to accommodate essential witnesses who are unable or unwilling to travel long distances for a hearing and may not otherwise be required to participate in the hearing; (3) to expedite large or complex cases; and (4) to address unusual situations where the arbitrator(s) determines that circumstances warrant departure from the general rule. Balanced against the authority of the arbitrator(s) to permit depositions, however, is the traditional reservation about the overuse of depositions in arbitration.

VII. Admissibility

Production of documents in discovery does NOT create a presumption that the documents are admissible at the hearing. A party may state objections to the introduction of any document as evidence at the hearing to the same extent that any other objection may be raised in arbitration.

VIII. Sanctions

The arbitration panel should issue sanctions if any party fails to produce documents or information required by a written order, unless the panel<sup>12</sup> finds that there is "substantial justification" for the failure to produce the documents or information. The panel has wide discretion to address noncompliance with discovery orders. For example, the panel may make an adverse inference against a party or assess adjournment fees, forum fees, costs and expenses, and/or attorneys' fees caused by noncompliance. In extraordinary cases, the panel may initiate a disciplinary referral against a registered entity or person who is a party or witness in the proceeding or may, pursuant to Rule 10305(b), dismiss a claim, defense, or proceeding with prejudice as a sanction for intentional failure to comply with an order of the arbitrator(s) if lesser sanctions have proven ineffective.

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Document Production Lists

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List 1

Documents to be Produced in all Customer Cases<sup>13</sup>

Firm/Associated Persons(s)

(1) All agreements with the customer, including, but not limited to, account

<sup>12</sup> As with other rulings, an arbitration panel's ruling need only be by majority vote; it need not be unanimous.

<sup>13</sup> Only named parties must produce documents pursuant to the guidelines set forth herein. However, non-parties may be required to produce documents pursuant to a subpoena or an arbitration panel order to direct the production of documents (see Rule 10322). In addition, the arbitration

opening documents, cash, margin, and option agreements, trading authorizations, powers of attorney, or discretionary authorization agreements, and new account forms.

(2) All account statements for the customer's account(s) during the time period and/or relating to the transaction(s) at issue.

(3) All confirmations for the customer's transaction(s) at issue. As an alternative, the firm/Associated Person(s) should ascertain from the claimant and produce those confirmations that are at issue and are not within claimant's possession, custody, or control

(4) All "holding (posting) pages" for the customer's account(s) at issue or, if not available, any electronic equivalent.

(5) All correspondence between the customer and the firm/Associated Person(s) relating to transaction(s) at issue

(6) All notes by the firm/Associated Person(s) or on his/her behalf, including entries in any diary or calendar, relating to the customer's account(s) at issue.

(7) all recordings and notes of telephone calls or conversations about the customer's account(s) at issue that occurred between the Associated Persons(s) and the customer (and any person purporting to act on behalf of the customer), and/or between the firm and the Associated Person(s).

(8) All Forms RE-3, U-4, and U-5, including all amendments, all customer complaints identified in such forms and all customer complaints of a similar nature against the Associated Person(s) handling the account(s) at issue.

(9) All sections of the firm's Compliance Manual(s) related to the claims alleged in the statement of claim, including any separate or supplemental manuals governing the duties and responsibilities of the Associated Person(s) and supervisors, any bulletins (or similar notices) issued by the compliance department, and the entire table of contents index to each such Manual.

(10) All analyses and reconciliations of the customer's account(s) during the time period and/or relating to the transaction(s) at issue.

(11) All records of the firm/Associated Person(s) relating to the customer's account(s) at issue, such as, but not limited to, internal reviews and exception and activity reports which reference the customer's account(s) at issue.

(12) Records of disciplinary action taken against the Associated Person(s) by any regulator or employer for all sales practices or conduct similar to the conduct alleged to be at issue.

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LIST 2

Documents to be Produced in All Customer Cases

CUSTOMER

(1) All customer and customer-owned business (including partnership or corporate federal income tax returns, limited to pages 1 and 2 of Form 1040, Schedules B, D, and E, or the equivalent for any other type of

chairperson may use the Document Production Lists as guidance for discovery issues involving non-parties.

return, for the three years prior to the first transaction at issue in the statement of claim through the date of the statement of claim was filed.

(2) Financial statements or similar statements of the customer's assets, liabilities and/or net worth for the period(s) covering the three years prior to the first transaction at issue in the statement of claim through the date the statement of claim was filed.

(3) Copies of all documents the customer received from the firm/Associated Person(s) and from any entities in which the customer invested through the firm/Associated Person(s), including monthly statements, opening account forms, confirmations, prospectuses, annual and periodic reports, and correspondence.

(4) Account statements and confirmations for accounts maintained at securities firms other than the respondent firm for the three years prior to the first transaction at issue in the statement of claim through the date the statement or claim filed.

(5) All agreements, forms, information, or documents relating to the account(s) at issue signed by or provided by the customer to the firm/Associated Person(s).

(6) All account analyses and reconciliations prepared by or for the customer relating to the account(s) at issue.

(7) All notes, including entries in diaries or calendars, relating to the account(s) at issue.

(8) All recordings and notes of telephone calls or conversations about the customer's account(s) at issue that occurred between the Associated Person(s) and the customer (any person purporting to act on behalf of the customer).

(9) All correspondence between the customer (and any person acting on behalf of the customer) and the firm/Associated Person(s) relating to the account(s) at issue.

(10) Previously prepared written statements by persons with knowledge of the facts and circumstances related to the account(s) at issue, including those by accountants, tax advisors, financial planners, other Associated Person(s), and any other third party.

(11) All prior complaints by or on behalf of the customer involving securities matters and the firm's/Associated Person(s) response(s).

(12) Complaints/Statements of Claim and Answers filed in all civil actions involving securities matters and securities arbitration proceedings in which the customer has been a party, and all final decisions and awards entered in these matters.

(13) All documents showing action taken by the customer to limit losses in the transaction(s) at issue.

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List 3

Churning

Firm/Associated Person(s)

(1) All commission runs relating to the customer's account(s) at issue or, in the alternative, a consolidated commission report relating to the customer's account(s) at issue.

(2) All documents reflecting compensation of any kind, including commissions, from all sources generated by the Associated

Person(s) assigned to the customer's account(s) for the two months preceding through the two months following the transaction(s) at issue, or up to 12 months, whichever is longer. The firm may redact all information identifying customers who are not parties to the action, except that the firm/Associated Person(s) shall provide at least the least four digits of the non-party customer account number for each transaction.

(3) Documents sufficient to describe or set forth the basis upon which the Associated Person(s) was compensated during the years in which the transaction(s) or occurrence(s) in question occurred, including: (a) any bonus or incentive programs; and (b) all compensation and commission schedules showing compensation received or to be received based upon volume, type of product sold, nature of trade (e.g., agency v. principal), etc.

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**List 4**

*Churning*

Customer

No additional documents identified.

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**List 5**

*Failure to Supervise*

Firm/Associated Person(s)

(1) All commission runs and other reports showing compensation of any kind relating to the customer's account(s) at issue or, in the alternative, a consolidated commission report relating to the customer's account(s) at issue.

(2) All exception reports and supervisory activity reviews relating to the Associated person(s) and/or the customer's account(s) that were generated not earlier than one year before or not later than one year after the transaction(s) at issue, and all other documents reflecting supervision of the Associated Person(s) and the customer's account(s) at issue.

(3) Those portions of internal audit reports at the branch in which the customer maintained his/her account(s) that: (a) focused on the Associated Person(s) or the transaction(s) at issue; and (b) were generated not earlier than one year before or not later than one year after the transaction(s) at issue and discussed alleged improper behavior in the branch against other individuals similar to the improper conduct alleged in the statement of claim.

(4) Those portions of examination reports or similar reports following an examination or an inspection conducted by a state or federal agency or a self-regulatory organization that focused on the Associated Person(s) or the transaction(s) at issue or that discussed alleged improper behavior in the branch against other individuals similar to the improper conduct alleged in the statement of claim.

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**List 6**

*Failure to Supervise*

Customer

No additional documented identified.

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**List 7**

*Misrepresentation/Omissions*

Firm/Associated Person(s)

Copies of all materials prepared or used by the firm/Associated Person(s) relating to the transactions or products at issue, including research reports, prospectuses, and other offering documents, including documents intended or identified as being "for internal use only," and worksheets or notes indicating the Associated Person(s) reviewed or read such documents. As an alternative, the firm/Associated Person(s) may produce a list of such documents that contains sufficient detail for the claimant to identify each document listed. Upon further request by a party, the firm/Associated Person(s) must provide any documents identified on the list.

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**List 8**

*Misrepresentation/Omissions*

Customer

(1) Documents sufficient to show the customer's ownership in or control over any business entity, including general and limited partnerships and closely held corporations.

(2) Copy of the customer's resume.

(3) Documents sufficient to show the customer's complete educational and employment background or, in the alternative, a description of the customer's educational and employment background if not set forth in a resume produced under item 2.

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**List 9**

*Negligence/Breach of Fiduciary Duty*

Firm/Associated Person(s)

Copies of all materials prepared or used by the firm/Associated Person(s) relating to the transactions or products at issue, including research reports, prospectuses, and other offering documents, including documents intended or identified as being "for internal use only," and worksheets or notes indicating the Associated Person(s) reviewed or read such documents. As an alternative, the firm/Associated Person(s) may produce a list of such documents that contains sufficient detail for the claimant to identify each document listed. Upon further request by a party, the firm/Associated Person(s) must provide any documents identified on the list.

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**List 10**

*Negligence/Breach of Fiduciary Duty*

Customer

(1) Documents sufficient to show the customer's ownership in or control over any

business entity, including general and limited partnerships and closely held corporations.

(2) Copy of the customer's resume.

(3) Documents sufficient to show the customer's complete educational and employment background or, in the alternative, a description of the customer's educational and employment background if not set forth in a resume produced under item 2.

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**List 11**

*Unauthorized Trading*

Firm/Associated Person(s)

(1) Order tickets for the customer's transaction(s) at issue.

(2) Copies of all telephone records, including telephone logs, evidencing telephone contact between the customer and the firm/Associated Person(s).

(3) All documents relied upon by the firm/Associated Person(s) to establish that the customer authorized the transaction(s) at issue.

\* \* \* \* \*

**List 12**

*Unauthorized Trading*

Customer

1. Copies of all telephone records, including telephone logs, evidencing telephone contact between the customer and the firm/Associated Person(s).

2. All documents relied upon by the customer to show that the transaction(s) at issue was made without his/her knowledge or consent.

\* \* \* \* \*

**List 13**

*Unsuitability*

Firm/Associated Person(s)

(1) Copies of all materials prepared, used, or reviewed by the firm/Associated Person(s) related to the transactions or products at issue, including but not limited to research reports, prospectuses, other offering documents, including documents intended or identified as being "for internal use only," and worksheets or notes indicating the Associated Person(s) reviewed or read such documents. As an alternative, the firm/Associated Person(s) may produce a list of such documents. Upon further request by a party, the firm/Associated Person(s) must provide any documents identified on the list.

(2) Documents sufficient to describe or set forth the basis upon which the Associated Person(s) was compensated in any manner during the years in which the transaction(s) or occurrence(s) in question occurred, including, but not limited to: (a) any bonus or incentive program; and (b) all compensation and commission schedules showing compensation received or to be received based upon volume, type of product sold, nature of trade (e.g., agency v. principal), etc.

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**List 14***Unsuitability*

## Customer

(1) Documents sufficient to show the customer's ownership in or control over any business entity, including general and limited partnerships and closely held corporations.

(2) Written documents relied upon by the customer in making the investment decision(s) at issue.

(3) Copy of the customer's resume.

(4) Documents sufficient to show the customer's complete educational and employment background or, in the alternative, a description of the customer's educational and employment background if not set forth in a resume produced under item 3.

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## II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, NASD Regulation included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD Regulation has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

### A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

#### 1. Purpose

The Discovery Guide, which includes Document Production Lists, provides guidance to parties on which documents they should exchange without arbitrator or staff intervention, and to arbitrators in determining which documents customers and member firms or associated persons are presumptively required to produce in customer arbitrations. The NASD developed the Discovery Guide because parties and their attorneys often do not comply or do not comply fully with discovery requests in NASD arbitrations. The proposal will streamline discovery in arbitrations in several ways, including reducing the number and scope of document productions and other discovery disputes, thereby reducing staff, arbitrator and party resources required to resolve such disputes. The Discovery Guide is a consensus document. It was developed over more than a two-year period, and reflects the view of many arbitration experts, experienced practitioners, and self-

regulatory organization ("SRO") arbitration staff.

The Discovery Guide and Document Production Lists will function as a guide for the parties and the arbitrators; they are not intended to bind arbitrators in a given case or to bind parties. For instance, arbitrators can order the production of documents not provided for by the Document Production Lists or alter the production schedule described in the Discovery Guide. Further, nothing in the Discovery Guide precludes the parties from voluntarily agreeing to an exchange of documents in a manner different from that set forth in the Discovery Guide or in the Document Production Lists. In fact, the Office of Dispute Resolution ("ODR") of NASD Regulation encourages the parties to agree to the voluntary exchange of documents and information and to stipulate to various matters. However, the Discovery Guide is binding on parties to the extent it is used by arbitrators to order the exchange of documents.

#### Background

In January 1996, the Arbitration Policy Task Force ("Task Force"), in *Securities Arbitration Reform: Report of the Arbitration Policy Task Force to the Board of Governors of NASD* ("Task Force Report"), made a number of broad recommendations to the NASD Board of Governors to improve the securities arbitration process administered by the NASD Board of Governors to improve the securities arbitration process administered by the NASD. One of these recommendations states that: "Automatic production of essential documents should be required for all parties, and arbitrators should play a much greater role in directing discovery and resolving discovery disputes."<sup>14</sup> The Task Force reported that parties and their attorneys routinely failed to comply with discovery requests or only complied partially. In addition, the Task Force noted that existing NASD rules did not provide guidance to an arbitrator as to the proper scope of discovery and, thus, discovery disputes were resolved largely according to the standards of individual arbitrators.<sup>15</sup> According to the Task Force, some arbitrators had experience in civil litigation, but others had little knowledge or training that would enable them to resolve a dispute according to any uniform standard or rules.<sup>16</sup>

After the work of the Task Force was completed, several groups were formed

to work on the discovery issue. Each group was composed of persons offering diverse perspectives, and all made a substantial contribution to the process. The proposed Discovery Guide is the product resulting from these groups' efforts which were composed of arbitration experts, experienced practitioners, and SRO arbitration staff. Among those contributing to the Discovery Guide were persons who are members of the Securities Industries Conference on Arbitration ("SICA")<sup>17</sup>, members of the Securities Industry Association ("SIA"), directors of the Public Investors Arbitration Bar Association ("PIABA"), industry representatives from major broker-dealers, counsel for claimants, and counsel for the industry. The Discovery Guide represents a compromise reached over more than two years among a variety of securities industry and investor representatives and their counsel. Most of the contributors believe the proposal represents an opportunity to improve discovery in arbitration.

The approval of the Discovery Guide would result in the implementation of key recommendations of the Task Force by establishing the practice in customer arbitrations that essential documents will be produced, and requiring that arbitrators play a greater role in directing the discovery process and resolving discovery disputes. The Discovery Guide follows the Task Force's recommendation in all but one respect. Although the Task Force recommended that any proposed arbitration rule or guideline require that documents be produced automatically, the Discovery Guide is drafted so that the documents are presumptively discoverable instead to give the arbitrators more discretion in managing the discovery process and to provide more flexibility to the process.

#### Features of the Discovery Guide

The Discovery Guide will be used as a supplement or an addendum to the guidance regarding discovery set forth in The Arbitrator's Manual, published by SICA, and particularly the provisions in the section entitled, "Prehearing Conference," at pages 11-16. The Arbitrator's Manual is compiled by members of SICA as a guide for arbitrators, and is designed to

<sup>17</sup> SICA was formed to develop and maintain a Uniform Code of Arbitration and to provide a forum for the discussion of new developments in securities arbitration among arbitration SRO forums and participants in those forums. The membership includes representatives from the SRO's with securities arbitration forums, three of four "public" members, and a representative from the SIA.

<sup>14</sup> *Task Force Report* at 2.

<sup>15</sup> *Id.* at 79.

<sup>16</sup> *Id.*

supplement and explain the Uniform Code of Arbitration as developed by SICA. By the terms of The Arbitrator's Manual, the procedures and policies contained therein are discretionary and may be changed by the arbitrators. Further, nothing in the Discovery Guide, including The Document Production Lists, precludes the parties from voluntarily agreeing to an exchange of documents in a manner different from that set forth in the Discovery Guide.

The Discovery Guide consists of introductory and instructional text, and fourteen Document Production Lists. It is intended for use by arbitrators in customer arbitrations only. These lists include the following (parenthetical references refer to the party from whom documents are sought):

- List 1: Documents To Be Produced In All Customer Cases (Firm/Associated Person(s))
- List 2: Documents To Be Produced In All Customer Cases (Customer)
- List 3: Churning (Firm/Associated Person(s))
- List 4: Churning (Customer)
- List 5: Failure To Supervise (Firm/Associated Person(s))
- List 6: Failure To Supervise (Customer)
- List 7: Misrepresentation/Omission (Firm/Associated Person(s))
- List 8: Misrepresentation/Omission (Customer)
- List 9: Negligence/Breach Of Fiduciary Duty (Firm/Associated Person(s))
- List 10: Negligence/Breach Of Fiduciary Duty (Customer)
- List 11: Unauthorized Trading (Firm/Associated Person(s))
- List 12: Unauthorized Trading (Customer)
- List 13: Unsuitability (Firm/Associated Person(s))
- List 14: Unsuitability (Customer).

The ODR will provide the parties with the Discovery Guide including the Document Production Lists at the time ODR serves the statement of claim. The document production requirements in the first two Document Production Lists, "List 1, Documents To Be Produced In All Customer Cases: (Firm/Associated Person(s))," and "List 2, Documents To Be Produced In All Customer Cases: Customer," would apply in virtually all cases involving member-customer or associated person-customer disputes, unless the arbitrator(s), in the exercise of discretion, determines that some or all of the documents in the relevant Document Production Lists should not be produced. For cases in which allegations of churning, failure to supervise, misrepresentation/omission, negligence/breach of fiduciary duty, unauthorized trading, or unsuitability are stated, additional Document Production Lists (e.g., Document Production Lists 3 and 4—Churning) provide additional guidance. If a

Document Production List is applicable, the Discovery Guide is drafted to guide the arbitrator(s) to order production, unless in the exercise of discretion, the arbitrator(s) believes that there is good cause not to order production.

In addition to specific document production requirements, the Discovery Guide also discusses other topics such as confidential treatment of documents, additional discovery requests, depositions, admissibility of evidence, arbitrator participation, and sanctions. These general instructions are discussed below.

**Confidential Treatment.** Under the Discovery Guide, parties may stipulate that private or confidential document(s) will not be disclosed or used in any manner outside of the arbitration of the particular case. Alternatively, the arbitrator(s) may issue confidentiality orders. The Discovery Guide further provides that arbitration panels shall not issue orders or use confidentiality agreements to require parties to produce documents otherwise protected by established privileges.

**Additional Discovery Requests.** The Discovery Guide states that parties may request documents in addition to those identified in the Document Production Lists, and it provides guidance regarding the timing of such requests. Unless a longer period is allowed by the requesting party, requests should be satisfied or objected to within 30 days from the date of service of the document request. Any response to objections to a request should be served on all parties within 10 days of service of the objection.

The Discovery Guide provides a mechanism for a party to seek to compel production of documents when the adverse party (a) refuses to produce such documents or (b) offers only to produce alternative documents that are unacceptable to the requesting party. The Discovery Guide directs the arbitrator(s) to carefully consider such motions, regardless of whether the item requested is on any of the Document Production Lists.

**Depositions.** The Discovery Guide enables the arbitrator(s) to allow depositions, but only under very limited circumstances, such as: (a) to preserve the testimony of ill or dying witnesses; (b) to accommodate essential witnesses who are unable or unwilling to travel long distances for a hearing and may not otherwise be required to participate in the hearing; (c) expedite large or complex cases; and (d) to address unusual situations where the arbitrator(s) determines that circumstances warrant departure from the general guidance.

**Admissibility.** Production of documents pursuant to the Discovery Guide does not create a presumption that the documents are admissible at the arbitration hearing. Nothing in the Discovery Guide prevents a party from objecting to the introduction of any document as evidence at the hearing to the same extent that any other objection may be raised in arbitration.

**Arbitrator Participation.** Under the Discovery Guide, the NASD arbitrator(s) will participate in the initial and subsequent prehearing conferences to organize the management of the case, set a discovery cut-off date, identify dispositive or other potential motions, schedule hearing dates, determine whether mediation is desirable, and resolve any other preliminary issues. If the exchange of properly requested discovery has not occurred, the Discovery Guide provides that the arbitrator(s) may order the production of all required documents subject to production.

**Sanctions.** The Discovery Guide instructs arbitration panels to issue sanctions if any party fails to produce documents or information required by a written order, unless the panel<sup>18</sup> finds that there is "substantial justification" for the failure to produce the documents or information. The Discovery Guide gives wide discretion to address noncompliance with discovery orders. For example, the panel may make an adverse inference against a party or assess adjournment fees, forum fees, cost and expenses, and/or attorney's fees caused by noncompliance. In extraordinary cases, the Discovery Guide permits the panel to initiate a disciplinary referral against a registered entity or person who is a party or witness in the proceeding or may, pursuant to Rule 10305(b), dismiss a claim, defense, or proceeding with prejudice as a sanction for intentional failure to comply with an order of the arbitrator(s) if lesser sanctions have proven ineffective.

#### *The Discovery Guide Is a Guideline*

As noted, the Discovery Guide will function as a guide for the parties and the arbitrator(s), and is intended to supplement The Arbitrator's Manual, which does not create any binding regulatory obligations. Further, the policies set forth in the Discovery Guide are discretionary and may be changed by the arbitrator(s). Moreover, the parties may agree to a voluntary exchange of documents in a manner that

<sup>18</sup> An arbitration panel's ruling need only be by majority vote; if need not be unanimous.

is different from that set forth in the Discovery Guide.

## 2. Statutory Basis

NASD Regulation believes that the proposed Discovery Guide is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's 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 NASD believes that the Discovery Guide will reduce the number and limit the scope of disputes involving document productions and other matters, thereby improving the arbitration process for the benefit of public investors, broker/dealer members, and associated persons who are the users of the process.

### B. Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed Discovery Guide will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

### C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

Written comments were neither solicited nor received.

## III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) by order approve such proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

## IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether utilizing the Discovery Guide, as amended, is consistent with the Act. In addition to any other issues that the public may wish to address, the Commission specifically requests comments on the

following aspects of the Discovery Guide:

### A. The Discovery Guide as a Compromise Document

The Discovery Guide provides guidance to parties on which documents they should exchange without arbitrator or staff intervention in NASD-sponsored arbitrations, and to arbitrators in determining which documents customers and member firms or associated persons are presumptively required to produce in customer arbitrations. In January 1996, the Arbitration Policy Task Force chaired by former Commission Chairman David Ruder recommended that "[a]utomatic production of essential documents should be required for all parties, and arbitrators should play a much greater role in directing discovery and resolving discovery disputes." *Task Force Report* (January 1996), at 2.

The NASD's National Arbitration and Mediation Committee, together with advisors from various diverse backgrounds, helped to draft the Discovery Guide over a period of two years in an effort to implement this recommendation. Among those contributing to the Discovery Guide were persons who are members of SICA, members of SIA, directors of PIABA, industry representatives, representatives from major broker-dealers, counsel for claimants, and counsel for the industry. The Discovery Guide reflects a compromise between the various interests of the drafters.

The Commission seeks comment on whether the Discovery Guide's document discovery lists, when considered as a whole, reflect a balanced compromise between the various interests of the drafters.

The Commission seeks comment on whether the Discovery Guides document discovery lists, when considered as a whole, reflect a balanced compromise between the production needs of, and burdens on, both claimants and industry defendants in customer arbitrations. For example, while some may believe production of a particular class of documents on one of the industry production lists is burdensome, there may be an equally burdensome production requirement on the corresponding customer production list. Comments should provide specific examples to support their views of whether the Discovery Guide is a balanced effort to make both sides in an arbitration produce more relevant documents more quickly. Comments should take into account that, as noted in the Discovery Guide, parties are not precluded from seeking additional

classes of documents either by agreement or by order of the arbitrators in any particular case.

### B. Customer Personal Financial Information

Under List 2 of the Discovery Guide, claimants in all cases are asked to produce a significant amount of personal financial information. For example, claimants are asked to produce portions of all customer and customer-owned business federal income tax returns (List 2, Item 1), financial statements or similar statements of the customer's assets, liabilities and or net worth (List 2, Item 2), and account statements and confirmations for accounts maintained at a securities firm other than the respondent firm (List 2, Item 4) for a period of at least three years and as many as six years.<sup>19</sup>

The Commission seeks comment on whether the scope of these requests on List 2 is reasonable in all customer cases. For example, should these requests be limited to a lesser amount of personal financial and tax information (e.g., either tax returns or financial statements), or to a shorter period of coverage (e.g., financial information covering a year before the transactions at issue until the date the claim is made)? Should federal income tax returns be made presumptively discoverable in only certain types of cases where the information contained in those documents may be more relevant (such as unsuitability cases (List 14)), than in other types of cases (such as churning claims)?

The Commission also seeks comment on whether the relative production burden is reasonably equivalent for both claimants and respondents in an arbitration proceeding. The drafters of the Discovery Guide sought to effect a compromise between competing interests, with each party being required to give up certain types of information in order to receive other types of information on a regular and timely basis. For example, does requiring customers to produce personal financial information (List 2, Items 1, 2, and 4) balance the respondent's obligation to produce records of customer complaints and disciplinary action, without time limitation (List 1, Items 8 and 12).<sup>20</sup>

<sup>19</sup>These requests seek documents covering the period from 3 years prior to the transaction(s) in issue through the time the claim is filed. Since most arbitration claims must be brought within 3 years from the date of the transaction under applicable statutes of limitations, depending on when a claim is filed, a claimant may have to produce 6 years' worth of personal financial information.

<sup>20</sup>List 1, Item 8 requires firms/associated persons to produce "[a]ll Forms RE-3, U-4, and U-5s, including all amendments, all customer complaints

Commenters should provide specific examples to support their opinions where possible.

### C. Privilege Issues

The Discovery Guide states in Part II.B. that "[t]he arbitrator(s) shall not issue an order or use a confidentiality agreement to require parties to produce documents otherwise subject to an established privilege." Those privileges that would be deemed "established," however, are not listed in the Guide. While the attorney-client privilege would clearly be an example of an established privilege, would it be helpful to parties and arbitrators to identify if other privileges also could be claimed? Do securities firms intend to assert any other types of privileges? Is the absence of specificity an invitation to argument about whether a privilege has been "established"?

As the NASD has stressed, the Lists of presumptively discoverable documents were the result of significant compromise between representatives of the industry, the plaintiffs' bar, and other interested persons. Each group agreed to include certain types of documents in the Lists that it could otherwise object to producing because it would receive other types of documents in return. Is the term "established privilege" sufficiently limited to assure that the balance between competing interests that the NASD sought to achieve through the Discovery Guide will not be upset?

The Commission therefore seeks comment on the privileges that should be considered "established" for purposes of the Discovery Guide. Should the only privilege recognized as "established" be the attorney/client privilege (and the related work product doctrine)? In light of the compromises reached in fashioning the Discovery Guide, should a party be precluded from asserting a blanket privilege to keep from producing an entire category of documents contained on one of the discovery Lists?

### D. Internal Audit Reports

List 5, Item 3(a) calls for the production of those portions of internal audit reports that "focused on" the associated person(s) or transaction(s) at issue. There may be instances where an internal audit report does not "focus

identified in such forms, and all customer complaints of a similar nature against the Associated Person(s) handling the account(s) at issue." List 1, Item 12 calls for production of "[r]ecords of disciplinary action taken against the Associated Person(s) by any regulator or employer for all sales practices or conduct similar to the conduct alleged to be at issue," in all cases.

on" a particular person or transaction, but may nonetheless relate to a claim made in arbitration. For example, an internal report that addresses a particular practice of the firm or branch office may be relevant to the customer's claim even if it does not "focus on" the associated person named in the customer's complaint.

Therefore, the Commission would like comment on whether the internal audit reports subject to production under List 5, Item 3(a) should be limited to those that "focus on" the associated person(s) or transaction(s) at issue in the claim, or whether the class of internal audit reports should be expanded to include those that "concern" or "relate to" the claims made in the arbitration. Is the limitation in List 5, Item 3(a) to reports that "focus on" the associated person(s) and transaction(s) at issue necessary to prevent production of audit reports that are unrelated to the claims in a particular arbitration, or does the limitation exclude particular types of reports that will almost always be relevant?

List 5, Item 3(b) requires production of those portions of internal audit reports that "were generated not earlier than one year before or not later than one year after the transaction(s) at issue and discussed alleged improper behavior in the branch against other individuals similar to the improper conduct alleged in the statement of claim." Does this provision help ensure that all portions of internal audit reports that may be relevant to the claims asserted in an arbitration will be produced by firms? Would an expansion of the documents called for in List 5, Item 3(a) upset the balance strived for by the members of the NASD's drafting committee?

### E. Particular Types of Claims

Lists 1 and 2 set forth documents to be produced in all customer cases by firms/associated persons and customers, respectively. Lists 3 through 14 call for the production of additional classes of documents in particular types of cases, including churning (Lists 3 and 4), failure to supervise (Lists 5 and 6), misrepresentation/omission (Lists 7 and 8), negligence/breach of fiduciary duty (Lists 9 and 10), unauthorized trading (Lists 11 and 12) and unsuitability (Lists 13 and 14). Are there other types of specific claims that should be included in particular lists in the Discovery Guide? For instance, claims alleging failure to obtain best execution on particular trades do not have individualized production lists. Because of the nature of best execution claims, the documents called for in List 11 may

be relevant in those cases. Should List 11 also apply to best execution claims as well as unauthorized trading claims? When commenting, commenters should take into account that recently best execution has become a topic of significant interest.<sup>21</sup>

Person making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0690. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-99-07 and should be submitted by May 14, 1999.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>22</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 99-10200 Filed 4-22-99; 8:45 am]

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-41298; File No. SR-OCC-99-05]

### Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing of Proposed Rule Change Regarding Joint Back Office Participants

April 16, 1999.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> notice is hereby given that on March 3, 1999, The Options Clearing Corp. ("OCC") filed with the Securities and Exchange Commission ("Commission") the proposed rule

<sup>21</sup> See, e.g., *Newton v. Merrill Lynch, Pierce, Fenner & Smith Incorporated, et al.*, 135 F.3d 266 (3d Cir. 1998); *Order Execution Obligations*, Exchange Act Release No. 37619A, 61 FR 48290 (Sept. 12, 1996) (duty of best execution requires broker-dealer to seek the most favorable terms reasonably available under the circumstances of the customer's transaction).

<sup>22</sup> 17 CFR 200.30-3(a)(12)

<sup>1</sup> 15 U.S.C. 78s(b)(1).