



VIA ELECTRONIC MAIL

September 24, 2018

Ms. Jennifer Piorko Mitchell
Office of the Corporate Secretary
The Financial Industry Regulatory Authority, Inc.
1735 K Street, NW
Washington, DC 20006-1506

**Re: Regulatory Notice 18-22 | FINRA Requests Comment on Proposed
Amendments to Its Discovery Guide to Require Production of Insurance
Information in Arbitration**

Dear Ms. Mitchell:

On July 26, 2018, the Financial Regulatory Authority, Inc. (FINRA) published Regulatory Notice 18-22, requesting public comment on proposed recommendations to amend the document production list that pertains to firms and advisors in customer arbitrations (Proposal).¹ More specifically, the Proposal would make information regarding a firm's or a financial advisor's third-party insurance coverage (Insurance Information) discoverable in customer arbitrations (Proposal).² Insurance Information would be presumptively discoverable, but the firm or the advisor would only be required to produce the information at the request of the customer or the customer's representative.³

Currently, Insurance Information is not presumptively discoverable. As such, customers or customer representatives seeking that information must request an order requiring the firm or the financial advisor to produce it. Arbitrators are not issued guidance with respect to how they should rule on these requests.⁴ FINRA has articulated that this lack of guidance may lead to inconsistent rulings.⁵

Acknowledging the potential prejudice that may arise if Insurance Information is disclosed to the arbitrators, FINRA proposes to only allow the information to be disclosed to arbitrators in two circumstances.⁶ First, disclosure would be permissible where there are extraordinary circumstances warranting it.⁷ Disclosure would, similarly, be permissible if the information is directly related to the underlying action.⁸ If the Proposal is adopted, FINRA also notes that it

¹ See, generally, FINRA Regulatory Notice 18-22 (July 26, 2018) (Notice).

² *Id.*

³ *Id.*

⁴ *Id.* at p. 3.

⁵ *Id.*

⁶ *Id.* at pp. 3-4.

⁷ *Id.*

⁸ *Id.*

would provide arbitrators with training designed to reduce the potentially prejudicial impact the Insurance Information may have on them.⁹

The Financial Services Institute¹⁰ (FSI) appreciates the opportunity to comment on this important proposal. FINRA notes that, currently, arbitrators lack guidance with respect to ruling on orders seeking production of insurance information and FSI agrees that the lack of arbitrator guidance regarding when, and whether, Insurance Information should be admissible is problematic. Thus, FSI supports FINRA issuing guidance to arbitrators related to circumstances under which they should rule in favor of a customer's proposed order seeking the production of Insurance Information. We believe that guidance will facilitate consistent rulings on this issue. Nonetheless, as discussed below, FSI's members are concerned that the unintended consequences of the Proposal may diminish investor protection, by making it more difficult for smaller sized firms to obtain, or maintain, insurance coverage. Since most unpaid arbitration awards derive from smaller sized firms,¹¹ any impediment on them obtaining or maintaining insurance may cause an increase unpaid customer arbitration awards. The Proposal also effectively penalizes firms that have third-party insurance coverage because it makes them vulnerable to having to pay higher monetary compensation for unfavorable arbitration awards. Firms without third-party insurance would not have the same vulnerabilities.

Background on FSI Members

The independent financial services community has been an important and active part of the lives of American investors for more than 40 years. In the US, there are more than 160,000 independent financial advisors, which account for approximately 52.7 percent of all producing registered representatives.¹² These financial advisors are self-employed independent contractors, rather than employees of the Independent Broker-Dealers (IBD).¹³

FSI's IBD member firms provide business support to independent financial advisors in addition to supervising their business practices and arranging for the execution and clearing of customer transactions. Independent financial advisors are small-business owners and job creators with strong ties to their communities. These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans. Their services include financial education, planning, implementation, and investment monitoring. Due to their unique business model, FSI member firms and their affiliated financial advisors are especially well positioned to provide Main Street Americans with the affordable financial advice, products, and services necessary to achieve their investment goals.

⁹ *Id.* at p. 3.

¹⁰ The Financial Services Institute (FSI) is an advocacy association comprised of members from the independent financial services industry, and is the only organization advocating solely on behalf of independent financial advisors and independent financial services firms. Since 2004, through advocacy, education and public awareness, FSI has been working to create a healthier regulatory environment for these members so they can provide affordable, objective financial advice to hard-working Main Street Americans.

¹¹ See Discussion Paper, note 20, *infra* at p. 7.

¹² Cerulli Associates, Advisor Headcount 2016, on file with author.

¹³ The use of the term "financial advisor" or "advisor" in this letter is a reference to an individual who is a registered representative of a broker-dealer, an investment adviser representative of a registered investment adviser firm, or a dual registrant. The use of the term "investment adviser" or "adviser" in this letter is a reference to a firm or individual registered with the SEC or state securities division as an investment adviser.

FSI members make substantial contributions to our nation's economy. According to Oxford Economics, FSI members nationwide generate \$48.3 billion of economic activity. This activity, in turn, supports 482,100 jobs including direct employees, those employed in the FSI supply chain, and those supported in the broader economy. In addition, FSI members contribute nearly \$6.8 billion annually to federal, state, and local government taxes. FSI members account for approximately 8.4% of the total financial services industry contribution to U.S. economic activity.¹⁴

Discussion

FSI appreciates the opportunity to comment on FINRA's Proposal. As stated above, FSI supports FINRA offering additional guidance to arbitrators regarding when to issue an order for production of insurance coverage information. Even absent this Proposal, that guidance would be helpful in ensuring that arbitrators are weighing the same, or substantially similar, factors; thereby achieving consistent determinations on these requests.

Nonetheless, FSI members are concerned about the potential unintended consequences of the Proposal, including that it: (i) may make insurance coverage financially prohibitive for smaller sized firms, thereby leading to an increase in unpaid customer arbitration awards; (ii) unintentionally penalizes firms that have third-party insurance coverage because these firms would primarily suffer from the Proposal's disadvantages (e.g., higher monetary payouts); and (iii) encourages customers and customers representatives to "plead into coverage," which will result in customers and their representatives propounding allegations tailored to the firms' or advisors' coverage leading the disclosures in BrokerCheck to be incomplete or deceptive. Finally, while FSI supports FINRA offering additional training to its arbitrators, it is doubtful that training will be sufficient to overcome the potential prejudice. These concerns are discussed in greater detail below.

I. The Proposal May Lead to Unintended Consequences Compromising Investor Protection and Unfairly Penalizing Firms with Third-party Insurance Coverage

A. Introduction

Pursuant to FINRA Rule 12506, parties to a FINRA arbitration will be notified via FINRA's website where to find FINRA's Discovery Guide (Guide). FINRA Rule 12506 also sets forth which documents, included in the Guide, are presumed discoverable in customer arbitrations and proscribes the time frames for producing those documents. Parties may also request that FINRA provide a hard copy of the Guide.¹⁵ List 1 of the Guide - Documents the Firm/Associated Persons Shall Produce in All Customer Cases (List 1) - details the documents that firms will be required to produce, absent a showing that the information should be excluded on some valid and permissible basis.¹⁶

For the most part, List 1 pertains to documents that are related to the customer's account, risk tolerance, communications between the customer and the firm or the advisor, supervision of the advisor and/or of the branch where the alleged misconduct occurred, the firm's or advisor's

¹⁴ Oxford Economics for the Financial Services Institute, The Economic Impact of FSI's Members (2016).

¹⁵ See FINRA Rule 12506(a).

¹⁶ See FINRA Discovery Guide (2013), at pp. 7-13, available at <https://www.finra.org/sites/default/files/ArbMed/p394527.pdf>.

compensation, and information required to assess the extent of the customer's damages.¹⁷ Without intending to offer an opinion on the relevancy of each and every document in List 1, FSI notes that there is a reasonable nexus between most of the documents to be produced, and the facts and circumstances of the customer's claim, including the customer's damages. There is no such nexus between those issues and the Insurance Information. The Insurance Information does not address the assessment of liability or damages. Even if that nexus did exist, the harm caused by the Proposal's unintended consequences would be substantially outweighed by any potential benefits promulgated in the Notice.

B. Production of the Insurance Information May Increase the Number of Unpaid Customer Arbitration Awards

FINRA notes that, "[t]he discovery of insurance information ... could increase the ability of customers to determine a litigation strategy to maximize the monetary compensation they could expect to receive."¹⁸ While well-intended, this increase in monetary compensation may have the unintended consequence of higher insurance premiums and, thus, an increase in smaller sized firm members who do not have access to affordable errors and omission (E&O) coverage. Reducing smaller firm's access to E&O coverage may also lead to an increase in unpaid customer arbitration awards, the exact opposite intended impact of the Proposal.

FSI works with several law firms, insurance providers, and other dedicated sponsors who provide services to its members. Among FSI's sponsors are insurers and insurance brokers who offer E&O coverage to advisors and broker dealers (Insurer Sponsors). FSI's Insurer Sponsors have reported that the expected increase in monetary payments stemming from customer arbitrations could, over time, result to an increase in firms' premium payments or retention¹⁹ amounts and more stringent requirements for firms to qualify for coverage. Larger firms may be able to absorb the increased expense, but small sized firms, particularly those with significant prior claim history, may find the increased cost of E&O insurance to be prohibitive. The Insurer Sponsors have also noted that some smaller firms already have difficulty obtaining coverage and, where the firm has prior claims history, finding coverage through a US insurer is very difficult. Thus, even for smaller sized firms that may be willing and/or able to absorb the increased cost for insurance, the Proposal may render them uninsurable.

Most unpaid customer arbitration awards involve awards obtained against smaller firms.²⁰ Thus, more than any other class of FINRA members, it is imperative that small firms have access to E&O coverage, and the coverage should not be made any more cost prohibitive for these firms than it already is. For this reason, the Proposal runs afoul of the very investor protection interests its endeavors to defend.

¹⁷ Id.

¹⁸ See Notice at p. 5.

¹⁹ Similar to a deductible, a retention is amount is the amount of the loss that the insured "retains".

²⁰ See Discussion Paper- FINRA Perspectives on Customer Recovery (Discussion Paper) at p. 7 (noting that "[u]npaid customer arbitration awards against firms primarily involve smaller-sized firms), available at http://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf.

C. Making Insurance Information Discoverable, Upon Request, May Penalize Firms Who Have Available Third-Party Coverage

FINRA states that it believes customers and their representatives are less likely to request Insurance Information from well capitalized firms.²¹ However, the basis for that belief is unclear and there is no assurance that this would in fact be the case.

Firms who have coverage will be required to produce this information which, as FINRA notes, may “maximize the monetary compensation.”²² These firms will be subject to possible higher payouts, resulting higher premiums and retention amounts, attorneys shaping their claims to fit within the available coverage, and will be more vulnerable to suffering prejudice where the arbitrators learn of the coverage. Consequently, these firms will be penalized for having E&O coverage. Firms without coverage will not be subject to these same penalties, which may disincentivize some firms from procuring coverage. FINRA should not adopt this Proposal, or any proposal, that would penalize firms, whether overtly or covertly, for having E&O coverage. That penalty may also cause some firms to cancel, or decline to purchase, coverage; particularly considering the increased cost discussed above. Shrinking the population of firms that have insurance would diminish investor protection, not increase it.

D. The Proposal Encourages “Pleading Into Coverage” Which May Cause Inaccurate or Misleading Information Regarding the Nature or the Character of the Firm’s or Financial Advisor’s Misconduct

FINRA notes that, “[b]y receiving details of the existence and scope of any third-party insurance coverage, a customer can decide whether to amend the statement of claim to fit within the coverage.” This practice, sometimes referred to as “pleading into coverage,” consists of the artful construction of a claim for the purposes of ensuring the claim, if successful, will be covered by the other party’s insurance. Again, this practice may increase monetary payments and, thus, increase insurance premiums. As explained above, this may lead to more unpaid customer arbitration awards.

In addition to its potential to escalate the amount of unpaid customer arbitration awards, pleading into coverage may lead to a misarticulation of the underlying issue. For instance, a customer, or customer representatives, may claim professional negligence even where the customer has actually suffered fraud. This customer may be encouraged to do so if the policy excludes coverage for fraud. It is paramount to investor protection that investors who deal with this firm or advisor in the future have a real, and genuine, understanding of the claims levied against the firm or advisor and the true nature and character of the advisor’s or firm’s misconduct. Thus, encouraging customers to “plead into coverage” frustrates this important investor protection.

Investors who review the arbitration information on FINRA’s website may not have an accurate depiction of the firm’s or the advisor’s conduct. Additionally, the arbitration information informs what is captured in BrokerCheck and, thus, disseminated to the investing public. It is fundamental that this information be relevant, useful and, most importantly, accurate. Information that is tailored to the firm’s or advisor’s insurance coverage, rather than to their conduct, is not relevant or useful. It is deceptive and misleading.

²¹ See Notice at p. 3.

²² See Notice at p. 5.

E. Production of The Insurance Information May Lead to Incurable Prejudice

The Notice explains that, “Although insurance information is presumptively discoverable in court, it is not usually introduced as evidence.”²³ Meaning, in most cases, insurance information is not presented to a jury. This is likely because, unlike a judge who has extensive legal training and experience, a jury does not have this training. Therefore, a jury is more likely to be prejudiced by any insurance information that is disclosed to it.

FINRA arbitrators are not required to have legal training or experience. Instead, arbitrators are required to have five years, or more, of professional experience and to have completed two years of college.²⁴ They also receive 13.5 hours of training.²⁵ In addition to that training, the Proposal promises to provide arbitrators with additional training to address potential prejudice.²⁶

By highlighting the distinctions between judges and arbitrators, FSI is in no way intending to diminish their expertise or the vastly important role they play in dispute resolution. Instead, FSI is merely affirming that arbitrators should be shielded from Insurance Information in the same manner that jurors are shielded from such information because, for these purposes, they are more analogous to juries than to judges. Merely limiting the circumstances under which the information may be submitted to them is not enough. In fact, it increases the probability of customer representatives seeking the information. Moreover, once the customer or his or her representative has the information, the Proposal may encourage the use of litigation tactics to ensure the information is disclosed to the arbitrators. Thus, the arbitrators will be prejudiced by information that bears little to no relation to the underlying claim. The prejudice is unlikely to be cured by a few additional hours of training.

II. If the Proposal Is Adopted, FINRA Should Publish Guidance Regarding the Extraordinary Circumstances Under Which Information Should be Presented to Arbitrators

Under the Proposal, Insurance Information would be provided to the customer, or the customer’s representative, but would only be provided to the arbitrators in two circumstances, including where extraordinary circumstances warrant it. It is unclear what would constitute “extraordinary circumstances” and, consequently, it appears that it would be in the discretion of the arbitrators to determine if “extraordinary circumstances” exist. While FINRA may find it difficult to produce an exhaustive list of situations that would constitute “extraordinary circumstances,” without some guidance inconsistent rulings are highly probable. As a result, we call on FINRA to provide clear guidance concerning what constitutes an extraordinary circumstance.

III. FSI Supports FINRA Issuing Arbitrator Guidance on Proposed Orders for the Production of Insurance Information

Today, when a customer, or a customer’s representative, requests an order for production of insurance information, arbitrators do not have guidance on how to decide these requests. FINRA notes that this lack of guidance can lead to inconsistent rulings on the production of this information.²⁷ FSI agrees and, even absent FINRA adopting this Proposal, FSI believes it should

²³ *Id.* at p. 2.

²⁴ See *Become an Arbitrator Frequently Asked Questions (FAQs)*, question 6, available at <https://www.finra.org/arbitration-and-mediation/become-arbitrator-frequently-asked-questions-faq>.

²⁵ *Id.* at question 9.

²⁶ See Notice at p. 3.

²⁷ *Id.* at p. 4.

publish guidance that will assist arbitrators in making consistent decisions. That guidance should explain that, in general, an order to produce insurance information should only be granted, in the very limited and very rare circumstances, where the insurance information is directly relevant to the underlying claim. The guidance should explain that insurance information would be directly relevant to the underlying claim if, for example, the customer, or the customer's representative can proffer evidence that the customer: (i) had affirmative knowledge that the firm or the advisor had third-party insurance coverage; (ii) knew the nature and character of that insurance; and (iii) in engaging in the subject transaction, directly relied upon its knowledge of the insurance information. Orders to produce insurance information should only be granted in extraordinary circumstances and, in these cases, it should be the customer's or the customer representative's burden to prove relevancy and the existence of extraordinary circumstances.

Absent such (or similar) proofs, neither the firm nor the advisor should be required to produce insurance information. Where the customer or the customer's representative can offer proof that the customer acted in reliance on the coverage, the existence of such coverage may be deemed relevant to assessing liability and the extent of the customer's damages. Absent those circumstances, or similar circumstances, it is difficult to imagine a situation in which this information would be useful.

Conclusion

We are committed to constructive engagement in the regulatory process and welcome the opportunity to work with FINRA on this and other important regulatory efforts.

Thank you for considering FSI's comments. Should you have any questions, please contact me at (202) 393-0022.

A handwritten signature in blue ink that reads "Robin Traxler". The signature is written in a cursive style with a long horizontal line extending to the right.

Vice President, Advocacy Policy & Associate General Counsel