BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of Department of Enforcement, Complainant, vs. Josephthal & Co. Inc. New York, New York, Respondent.	DECISION Complaint No. CAF000015 Dated: May 6, 2002

Hearing Panel found that firm had violated just and equitable principles of trade when it failed to comply with an arbitration panel's order to produce a document. Held, findings and sanctions affirmed.

Josephthal & Co., Inc. ("Josephthal" or the "Firm") has appealed an April 18, 2001 decision of a Hearing Panel, and the Department of Enforcement ("Enforcement") has cross-appealed from the same decision. The Hearing Panel held that Josephthal violated Conduct Rule 2110 by failing to comply with an order of an NASD arbitration panel ("Arbitration Panel") to produce a document for *in camera* review. The Hearing Panel imposed sanctions against Josephthal of a censure and a $10,000 fine. We affirm the Hearing Panel's finding that Josephthal violated just and equitable principles of trade, and we also affirm the sanctions imposed.

Background

From May 1998 through September 1999, Josephthal was a respondent in an NASD arbitration proceeding (the "Josephthal arbitration") brought by two claimants. During pre-hearing discovery, the Arbitration Panel required Josephthal to respond to document requests and interrogatories propounded by the claimants. The claimants alleged that Josephthal had recommended the purchase of three unsuitable securities and had failed to disclose relevant facts relating to those securities.

The first hearing sessions were held from June 8 through June 10, 1999. Although the parties presented the bulk of their evidence during these three days, additional hearing sessions were scheduled in the months that followed. At the conclusion of the June 10 session, the Arbitration Panel permitted claimants to propound additional discovery requests on Josephthal. Consistent with the Arbitration Panel's ruling, on June 17, 1999, the claimants filed a written request that Josephthal produce several specific additional documents or categories of documents, including a request to produce "the report of the independent consultant, retained pursuant to the NASD order of June, [1996], pertaining to Josephthal's supervisory procedures."

On June 30, 1999, Josephthal filed a response to the claimants' request in which it stated that no such document existed. This response was accurate. The Firm then voluntarily disclosed the existence of another document, not previously requested by the claimants, that had been prepared by the law firm of Morgan, Lewis & Bockius ("Morgan Lewis memorandum") in connection with a 1996 New York Stock Exchange ("NYSE") proceeding. In addition to identifying the Morgan Lewis memorandum, Josephthal objected to producing it, stating that the document was protected by the attorney-client privilege. Josephthal stated that the Morgan Lewis memorandum contained legal advice regarding future compliance with the securities laws and NYSE rules. The Morgan Lewis memorandum had not been disclosed to any person or entity, including the NYSE, outside of the attorney-client relationship. On July 12, 1999, the Arbitration Panel granted claimants' discovery request for production of the Morgan Lewis memorandum.

On July 29, 1999, Josephthal filed a motion for reconsideration of the Arbitration Panel's order, arguing that the document was protected by the attorney-client privilege and, accordingly, was not subject to production in the arbitration. In support of its motion, Josephthal submitted an affidavit from its General Counsel attesting to the nature of the document, and describing underlying facts that led the Firm to consider it protected by the attorney-client privilege. Claimants did not dispute the facts set forth in the General Counsel's affidavit.

During oral argument before the Arbitration Panel on August 2, 1999, Josephthal addressed a proposal to have the document submitted to the panel for an *in camera* inspection. Arguing against that proposal, Josephthal noted its concern that such an act may be argued or held to be a waiver of the attorney-client privilege. Despite Josephthal's arguments, on August 2, 1999, the Arbitration Panel directed the Firm to produce the document for *in camera* inspection.

At that time, Josephthal proposed, as an alternative to *in camera* inspection, having an NASD attorney review the document under a "non-waiver agreement" to confirm that it was privileged. The Arbitration Panel did not accept Josephthal's alternative proposal and continued to instruct the Firm to produce the document for *in camera* inspection.

Josephthal declined to produce the document, citing a risk of waiving the attorney-client privilege for the Morgan Lewis memorandum. Josephthal informed the Arbitration Panel that it did not intend any disrespect toward the panel by its refusal to comply, and the Arbitration Panel noted that it did not interpret the Firm's refusal to produce the document for *in camera* inspection as disrespectful.

The Arbitration Panel advised Josephthal that it would refer the Firm's refusal to produce the document for *in camera* inspection to the NASD for whatever action the NASD deemed appropriate. The Arbitration Panel proceeded to complete its adjudication of the parties' substantive dispute and, on September 1, 1999, granted an award of $49,834 in compensatory damages to the claimants. Josephthal paid the award to the claimants in a timely manner.

Discussion

There is no dispute that Josephthal refused to produce the Morgan Lewis memorandum, which directly violated the Arbitration Panel's order. Whether this refusal is a violation of NASD Rules, and specifically Conduct Rule 2110, is the central issue in this appeal.

A. The Arbitration Panel's Authority

The Arbitration Panel's order to produce the document was explicitly authorized by the NASD Code of Arbitration Procedure. Arbitration Rule 10322(b) states that "The arbitator(s) shall be empowered without resort to the subpoena process to direct . . . the production of any records in the possession or control of such persons or members." In attempting to resolve the discovery dispute, the Arbitration Panel was well within its authority in ordering production of the Morgan Lewis memorandum for *in camera* review. Arbitration Rule 10324 provides:

> The arbitrators shall be empowered to interpret and determine the applicability of all provisions under this Code and to take appropriate action to obtain compliance with any ruling by the arbitrator(s). Such interpretations and actions to obtain compliance shall be final and binding upon the parties.

Josephthal's obligation to comply with the Arbitration Panel's orders is addressed by the Code of Arbitration Procedure in Interpretive Material ("IM")-10100 (Failure to Act Under Provisions of Code of Arbitration Procedure):

> It may be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 2110 for a member or a person associated with a member to: . . .

> (c) fail to appear or to produce any document in his possession or control as directed pursuant to provisions of the NASD Code of Arbitration Procedure

Because Josephthal failed "to produce any document" in its possession as directed by the Arbitration Panel, IM-10100 provides that Josephthal's conduct may be deemed to violate Conduct Rule 2110.

B. Requirements for Finding a Violation of Conduct Rule 2110

Josephthal contends that we must find that it acted unethically or in bad faith in order to sustain a finding that it violated Conduct Rule 2110. We disagree. We can find a violation of Conduct Rule 2110 based on violations of NASD arbitration rules because "members of the securities industry are expected and required to abide by the applicable rules and regulations." Department of Enforcement v. Shvarts, Compl. No. CAF980029, 2000 NASD Discip. LEXIS 6 (NAC June 2, 2000). For example, when a respondent engages in private securities transactions in violation of Conduct Rule 3040, that respondent also violates Conduct Rule 2110. See Jim Newcomb, Exchange Act Rel. No. 44945, 2001 SEC LEXIS 2172, *2 (Oct. 18, 2001) ("The NASD's finding that Newcomb violated Rule 2110 along with Rule 3040 is based on the long-standing policy that a violation of another NASD rule or regulation constitutes a violation of Rule 2110.") (citation omitted); Stephen J. Gluckman, Exchange Act Rel. No. 41628, 1999 SEC LEXIS 1395, *22 (July 20, 1999) (violation of another NASD or SEC rule or regulation constitutes a violation of Rule 2110).

Here, we find that Josephthal violated Conduct Rule 2110 because it violated Arbitration Rule 10322(b) and IM-10100.[1]

Josephthal argues in detail why its conduct was in good faith and therefore that it committed no violation of Conduct Rule 2110.[2] Because we have rejected a bad faith

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[1] Josephthal also argues that the word "may" in IM-10100 indicates that not every failure to produce a document as ordered by an arbitration panel violates just and equitable principles of trade and that there must be a finding of bad faith to support a violation of Conduct Rule 2110. We disagree with this interpretation of IM-10100. We find that IM-10100 uses the word "may" because arbitration panels have discretion whether to refer a member's refusal to produce a document to Enforcement for possible disciplinary action. Similarly, a disciplinary panel may find that a party to an arbitration failed to produce a document as directed by an arbitration panel, but determine that the action was of insufficient consequence to be deemed a violation of Conduct Rule 2110.

[2] Josephthal also argues that we must find that it acted in bad faith to find a violation of Conduct Rule 2110 because NASD and SEC disciplinary decisions for failure to honor an

[Footnote continued on next page]

requirement for finding a violation of Conduct Rule 2110 in this case, we do not address Josephthal's arguments in this section.

C. Attorney-Client Privilege

Josephthal argues that allowing the Arbitration Panel to examine the Morgan Lewis memorandum *in camera* would have risked waiving the attorney-client privilege.[3] Josephthal further argues that we must find that its interpretation of the law was in bad faith to find that it violated Conduct Rule 2110. We will not analyze whether Josephthal engaged in bad faith because we are not following a bad faith standard for finding liability. Rather, we evaluate the case law to determine whether Josephthal's position is correct that submitting the Morgan Lewis memorandum to the Arbitration Panel for *in camera* review would have waived the attorney-client privilege.

We find that the relevant case law supports the proposition that submitting documents to an arbitration panel for *in camera* review does not waive the attorney-client privilege. In GTE Directories Service, Corp. v. Pacific Bell Directory, 135 F.R.D. 187 (N.D. Cal. 1991), the court ruled that a party that submitted an attorney-client privileged document to a court-selected neutral evaluator did not waive the attorney-client privilege because the submission was confidential. Id. at 190. Because the neutral evaluator, who was not a judge, handled privileged documents confidentially, the reasoning of the GTE case applies to an arbitration panel conducting a confidential, *in camera* review of potentially attorney-client privileged documents. Just as the privilege was not waived in GTE, Josephthal would not have waived any privilege that the Morgan Lewis memorandum might have had if the Firm had followed the Arbitration Panel's order.

In PaineWebber Group, Inc. v. Zinsmeyer Trusts Partnership, 187 F.3d 988, 992 (8th Cir. 1999), the Eighth Circuit Court of Appeals suggested that *in camera* review of privileged documents by arbitrators does not waive the attorney-client privilege. There, the court held that an asset management firm did not employ undue means in order to win an arbitration when it asserted—in the course of an arbitration proceeding—that documents were privileged.

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arbitration award include findings of bad faith. Because neither Arbitration Rule 10322(b) nor IM-10100 includes a bad faith requirement, we will not create such a requirement here.

[3] Although Josephthal has not specified that federal law would govern the attorney-client privilege issue, Josephthal and Enforcement have argued this point with reference to federal law in non-diversity cases. Because the record does not contain evidence to the contrary, we too refer to federal law in addressing the attorney-client privilege question.

Id. at 992-93.[4] The court explained that the arbitrators required a party claiming attorney-client privilege to describe the documents in a privilege log, which the opposing party could use as the basis for a challenge to the claim of privilege. Id. at 992. "The party seeking discovery cannot see the allegedly privileged documents—that might waive the privilege—so the dispute is usually resolved by submitting them to the tribunal *in camera*." Id. The court's statement reasonably implies that *in camera* review of privileged documents by arbitrators does not waive the privilege.[5]

Josephthal argues that the Zinsmeyer decision does not hold that *in camera* review of privileged documents by an arbitrator does not waive the privilege. Although Josephthal is correct as to the court's precise holding, we find that Zinsmeyer's guidance on this issue is clear and the decision is more on point than any contrary authority. Josephthal has cited no cases that hold that an *in camera* submission to an arbitration panel of an attorney-client privileged document waives the attorney-client privilege as to that document.

Josephthal further argues that Zinsmeyer was issued a few weeks after the misconduct in this case, and therefore it cannot be relevant to the waiver of the attorney-client privilege question at issue here. We disagree. We find Zinsmeyer persuasive because it interpreted existing law on this issue at the time Josephthal determined not to produce the Morgan Lewis memorandum.[6]

Moreover, we find that the Arbitration Panel's order that Josephthal produce the Morgan Lewis memorandum for *in camera* review in spite of Josephthal's objection means

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[4] The court also held that the arbitration award should be upheld because the firm did not procure the favorable arbitration award by undue means and because, assuming the firm had used undue means, the claim of privilege did not affect the arbitration hearing record. Id. at 994.

[5] Cf. Olson v. National Ass'n of Sec. Dealers, 85 F.3d 381, 382 (8th Cir. 1996) ("Because an arbitrator's role is functionally equivalent to a judge's role, courts of appeal have uniformly extended judicial and quasi-judicial immunity to arbitrators.") (citations omitted); Austern v. Chicago Bd. Options Exch., Inc., 898 F.2d 882, 886 (2d Cir.) cert. denied, 498 U.S. 850 (1990) (finding functional comparability between the role of judge and arbitrator).

[6] We also find helpful the court's discussion in Merrill Lynch, Pierce, Fenner & Smith v. Lambros, 1 F. Supp. 2d 1337 (M.D. Fla. 1998), aff'd, 214 F.3d 1354 (11th Cir. 2000) (unpublished table case). There, the court ruled that an arbitration award would not be vacated based on an allegation that a party redacted material from documents when the record showed that the arbitration panel, during *in camera* review, redacted attorney-client matters from the documents. Id. at 1345-46.

that Josephthal's submission of the document would have been compelled. Disclosure of an attorney-client privileged document constitutes a waiver of the attorney-client privilege only if it is voluntary and not compelled. See Transamerica Computer Co. v. International Business Machines, 573 F.2d 646, 651 (9th Cir. 1978) (relying on proposed Federal Rules of Evidence Rules 511 and 512 in holding that disclosure of confidential material constitutes a waiver of the attorney-client privilege only if it is voluntary and not compelled); Teachers Ins. and Annuity Assoc. v. Shamrock Broadcasting Co., 521 F. Supp. 638, 641 (S.D.N.Y. 1981) (finding that disclosure of an attorney-client privileged document is not a waiver if it is compelled by court order). Therefore, if Josephthal had complied with the Arbitration Panel's order, the case law indicates that it would not have waived any attorney-client privilege that the Morgan Lewis memorandum might have had.

We find that the relevant legal authorities support the conclusion that submission of a document to an arbitration panel for *in camera* review, pursuant to an order issued by that panel, does not waive the attorney-client privilege.

In summary, we conclude that Josephthal violated Conduct Rule 2110, in contravention of Arbitration Rule 10322(b) and IM-10100, when it disobeyed an arbitration panel's order to produce a document. We reject as incorrect the contention that we must find that Josephthal acted in bad faith as an additional element of such a violation.

Sanctions

The Hearing Panel imposed sanctions of a censure and a $10,000 fine. On appeal, Josephthal argues that if we find a violation in this case, Josephthal should be issued a letter of caution. In its cross-appeal, Enforcement argues that Josephthal should be fined $30,000. We accept neither of the litigants' positions. As discussed below, we consider a $10,000 fine to be the appropriate amount in light of all of the facts and circumstances of this case.

There are no NASD Sanction Guidelines ("Guidelines") that specifically address a firm's refusal to honor an arbitration panel's order to produce a document. We primarily take guidance from the "General Principles Applicable To All Sanction Determinations" contained in the Guidelines.[7] The third general principle advises that adjudicators should tailor sanctions to respond to the misconduct at issue. Because Josephthal timely paid the award in the Josephthal arbitration, we do not rely on the Guideline for failure to pay an arbitration award. Likewise, we do not follow Enforcement's suggestion that we take guidance from the Guideline for failure to respond to NASD requests made pursuant to Procedural Rule 8210. Violations of Procedural Rule 8210 are uniquely serious because they directly subvert the NASD's ability to carry out its regulatory duties.

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[7] See NASD Sanction Guidelines (2001 ed.) at 3-8.

Based on the facts of this case, we consider the following factors in determining the seriousness of the misconduct: (1) whether Josephthal's claim that producing the document for *in camera* review would waive the attorney-client privilege was correct; (2) how the arbitrators treated Josephthal's refusal to produce the document; and (3) what measures, if any, Josephthal took to respond to the arbitrator's order without disobeying it.

A. Attorney-Client Privilege

As discussed in the liability section, we conclude that an arbitration panel's *in camera* review of a document does not waive the attorney-client privilege. We return to this issue in assessing sanctions for the purpose of evaluating whether Josephthal had a reasonable basis to believe that its conduct did not violate Arbitration Rule 10322(b) and IM-10100. The standard that we use to determine whether we should increase the Hearing Panel's $10,000 fine is whether Josephthal's refusal to produce the document was based on a frivolous argument.

Josephthal argues that—even if the law is what we have found it to be—its actions were reasonable because there was a risk of a court ruling that it had waived the attorney-client privilege if it had allowed the *in camera* review. We find that this argument is not frivolous because, in general, several courts have instructed that clients and attorneys must carefully protect the attorney-client privilege and waiver of the attorney-client privilege should be liberally construed.[8] Nevertheless, as previously discussed, we find that the court decisions referred to lead to the conclusion that Josephthal's submission of the Morgan Lewis memorandum to the arbitration panel for *in camera* review would not have waived the attorney-client privilege, if such privilege existed. Because we find that Josephthal's refusal to produce the document was not based on a frivolous argument, we will not impose the more severe monetary sanctions that may be necessary to deter a respondent that had violated the arbitration rules without any basis whatsoever.

B. Arbitration Panel's Actions

NASD arbitration panels have broad powers to manage the cases before them, and the exercise of those powers is essential to the effectiveness and fairness of the arbitration system. Panels are charged with determining the relevance and materiality of all evidence proffered in the arbitration without being bound by the rules of evidence. Arbitration Rule 10323. Moreover, they are empowered to interpret the applicability of the Code of Arbitration Procedure and "take appropriate action to obtain compliance with any ruling by the

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[8] See, e.g., United States v. Nixon, 418 U.S. 683, 709-10 (1974); In re Sealed Case, 877 F.2d 976, 980 (D.C. Cir. 1989).

arbitrator(s)." Arbitration Rule 10324. In addition, arbitrators fulfill a critical role in a highly beneficial program. See Jerry L. Marcus, 47 S.E.C. 72, 74 (1979) ("The NASD's Code of Arbitration Procedure provides its members, their employees, and their public customers with a very useful mechanism for resolving disputes.") (citation omitted).

In the Josephthal arbitration, after Josephthal refused to produce the Morgan Lewis memorandum, the Arbitration Panel completed the hearing and advised Josepthal that it would formally refer Josephthal's refusal to produce the document to the NASD for possible disciplinary action. The Arbitration Panel did not impose any discovery sanctions on Josephthal. One month after the conclusion of the arbitration hearing, the Arbitration Panel issued an award in favor of the claimants for $49,834 in compensatory damages and no punitive damages. Claimants had requested approximately $80,000 in compensatory damages and $110,000 in punitive damages.

Based on the record before us, we conclude that the Arbitration Panel did not consider the Morgan Lewis memorandum essential to its ability to reach a judgment.[9] The Arbitration Panel issued its award without mentioning the Morgan Lewis memorandum or Josephthal's failure to produce the memorandum for inspection.

Contrary to Enforcement's suggestion, we will not increase Josephthal's fine based on the difference between the arbitration claimants' request for compensatory damages and the amount the Arbitration Panel actually awarded. Enforcement states that this amount is $30,000. We reject Enforcement's approach because it incorrectly assumes that we should be interfering with the substantive result of the Josephthal arbitration. We should not and will not undertake that task. Rather, the sanctions we impose reflect our judgment as to a proper fine that Josephthal should pay for its refusal to abide by an arbitration panel's order.

C. Josephthal's Efforts to Resolve the Issue

Josephthal argues in mitigation that it did not lightly disregard the Arbitration Panel's order because it exhausted all possibilities of resolving the dispute before it decided to disobey the Arbitration Panel's order. We do not agree that Josephthal's actions qualify as mitigating circumstances. We consider the significant events, all of which happened in 1999, to be as follows: On June 30, Josephthal objected to producing the Morgan Lewis memorandum based on attorney-client privilege. On July 12, the Arbitration Panel issued a letter ruling that

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[9] We note that the Arbitration Panel could have drawn an adverse evidentiary inference against Josephthal based on its refusal to produce the Morgan Lewis memorandum. See Page International Ltd. v. Adam Maritime Corp., 53 F. Supp. 2d 591, 597 (S.D.N.Y. 1999). The record does not reflect whether the Arbitration Panel decided to draw such an inference or whether Josephthal's refusal in any other manner affected the Panel's determination.

required Josephthal to produce the Morgan Lewis memorandum. On July 29, Josephthal filed a motion for the Arbitration Panel to reconsider its ruling. At the arbitration hearing on August 2, the Arbitration Panel, in person, ordered Josephthal to produce the document for *in camera* review. The Arbitration Panel Chairman stated that the panel would review the document and "if we decide it's inadmissible we will return it to you."

The result of Josephthal's actions was to prevent the Arbitration Panel from reviewing the Morgan Lewis memorandum and making a ruling on attorney-client privilege and production to claimants. Moreover, we do not consider Josephthal's proposal to have an NASD attorney review the Morgan Lewis memorandum under a non-waiver agreement to be a meaningful attempt to comply with the arbitration rules. While parties and arbitration panels should be encouraged to resolve discovery and production issues creatively, if necessary, where they fail to do so an arbitration panel's authority must be observed. Consequently, we find that Josephthal's actions during the arbitration do not qualify as mitigating.

Josephthal further argues that allowing the Arbitration Panel to review the Morgan Lewis memorandum *in camera* would have risked a breach of the attorney-client privilege because the Arbitration Panel could have turned over the document to the claimants. We reject this proposition. First, we refuse to join Josephthal in speculating that the Arbitration Panel would have made an incorrect ruling or would have routinely disclosed the contested document to claimants. Josephthal's refusal to follow the Arbitration Panel's order is the sole reason why there was no ruling. Second, reducing the sanctions against Josephthal based on its purported concerns about how the Arbitration Panel may have ruled would undermine the authority of arbitrators to conduct hearings. We strongly support an arbitrator's authority under Arbitration Rule 10322 to order the production of any document in a party's control, and we disapprove of a party that participates in arbitration but seeks to reserve for itself the option to disobey rulings issued by an arbitrator.

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We have also considered the "Principal Considerations In Determining Sanctions" from the Guidelines. Josephthal has no relevant disciplinary history. The record contains no other instances of Josephthal failing to obey an arbitrator's order.

Conclusion

In summary, we conclude that Josephthal violated Conduct Rule 2110 when it refused to submit for *in camera* review a document over which the Firm asserted attorney-client privilege. Josephthal's conduct was contrary to the Code of Arbitration Procedure, which authorizes an arbitration panel to order parties to produce any documents in their possession. We hold that we need not find that Josephthal acted in bad faith to conclude that the Firm violated Conduct Rule 2110. Regarding sanctions, we conclude that although Josephthal's interpretation of the law regarding waiver of the attorney-client privilege was not supported

by the relevant case law, the Firm's position was not frivolous and the order of the Arbitration Panel was not central to the resolution of the arbitration.

Accordingly, we order that Josephthal be censured, fined $10,000, and ordered to pay appeal costs of $1,399.58 ($1,000 plus $399.58 for the transcript).[10]

On Behalf of the National Adjudicatory Council,

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Barbara Z. Sweeney
Senior Vice President and Corporate Secretary

[10] We have considered and reject without discussion all other arguments advanced by Josephthal and Enforcement.

Pursuant to NASD Procedural Rule 8320, any member that fails to pay any fine, costs, or other monetary sanction imposed in this decision, after seven days' notice in writing, will summarily be suspended or expelled from membership for non-payment.