

Discovery of Insurance Information in Arbitration

FINRA Requests Comment on Proposed Amendments to Its Discovery Guide to Require Production of Insurance Information in Arbitration

Comment Period Expires: September 24, 2018

Summary

FINRA is requesting comment on proposed amendments to the Discovery Guide's (Guide) Firm/Associated Persons Document Production List (Firm/Associated Persons List) to require firms and associated persons, upon request, to produce documents concerning third-party insurance coverage in a customer arbitration proceeding. The proposed amendments would strictly limit the circumstances under which insurance coverage information could be presented to the arbitrators.

The text of the proposed amendments is set forth in Attachment A.

Questions concerning this *Notice* should be directed to:

- ▶ Kenneth L. Andrichik, Senior Vice President and Chief Counsel, Office of Dispute Resolution, at (212) 858-3915; or
- ▶ Kristine Vo, Assistant Chief Counsel, Office of Dispute Resolution, at (212) 858-4106.

Action Requested

FINRA encourages all interested parties to comment on the proposal. Comments must be received by September 24, 2018.

Comments must be submitted through one of the following methods:

- ▶ Emailing comments to pubcom@finra.org; or

July 26, 2018

Notice Type

- ▶ Request for Comment

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Registered Representatives
- ▶ Senior Management

Key Topics

- ▶ Arbitration
- ▶ Code of Arbitration Procedure
- ▶ Discovery Guide
- ▶ Firm/Associated Persons Document Production List
- ▶ Insurance Information

Referenced Rules & Notices

- ▶ FINRA Rule 12212
- ▶ FINRA Rule 12407
- ▶ FINRA Rule 12506

- ▶ Mailing comments in hard copy to:
Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

To help FINRA process comments more efficiently, persons should use only one method to comment on the proposal.

Important Notes: All comments received in response to this *Notice* will be made available to the public on the FINRA website. In general, FINRA will post comments as they are received.¹

The proposed rule change must be filed with the Securities and Exchange Commission (SEC) pursuant to Section 19(b) of the Securities Exchange Act of 1934 (SEA).²

Background & Discussion

The Guide supplements the discovery rules contained in the FINRA Code of Arbitration Procedure for Customer Disputes (Customer Code).³ It includes an introduction that describes the discovery process generally, and explains how arbitrators should apply the Guide in arbitration proceedings. The introduction is followed by two Document Production Lists, one for firms and associated persons and one for customers, which enumerate the documents that are presumptively discoverable in customer cases. As presumptively discoverable, parties do not have to expressly request the documents. FINRA expects the parties to exchange the documents without arbitrator or staff intervention. The Guide only applies to customer arbitration proceedings, not to intra-industry cases.

FINRA's Dispute Resolution Task Force (Task Force)⁴ reviewed the Guide and concluded that insurance information would be beneficial to customers in arbitration proceedings. Therefore, the Task Force recommended that FINRA amend the Firm/Associated Persons List to provide for the production of insurance policies that may be applicable to a claimant's claims. Most state statutes require the production of insurance information, and insurance information is also discoverable under Federal discovery procedures.⁵ Although insurance information is presumptively discoverable in court, it is not usually introduced as evidence.

Practitioners who represent customers at the forum have told FINRA staff that insurance information is important during settlement discussions, especially with firms for which the ability to pay a potential award may be uncertain. These customer representatives believe that having knowledge of possible insurance, if any, would make them better able to advise their clients and determine a litigation strategy. Practitioners who represent the industry have raised concerns about insurance information being presumptively discoverable

because of the potential for an opposing party to leak the information to the arbitrators, which would be prejudicial to a firm or associated person. They caution that disclosing the existence of a policy could be misleading because insurance policies often contain exclusions and limits that might preclude payment to a customer. They also believe that FINRA should not require firms to produce insurance information automatically in every case because it may not be relevant if the ability to pay a potential award is not an issue in the case.

Since insurance information is not included on the Firm/Associated Persons List, and the Guide does not otherwise address the issue of insurance, customer representatives currently request insurance information separately under the Customer Code.⁶ Firms and associated persons often object to these requests, thereby requiring customer representatives to seek an arbitrator's ruling on a proposed order for production. Because the Guide does not currently provide guidance for arbitrators on the issue of insurance information, the lack of guidance can lead to inconsistent arbitrator rulings relating to production.

Proposed Amendments

FINRA is proposing to amend the Firm/Associated Persons List to add a new List Item (Item) requiring the production of information relating to insurance policies obtained through third-party carriers. The Item would not require production of documents relating to self-insurance. FINRA generally expects parties to produce documents responsive to the Items on their respective Document Production List without parties requesting them, and without staff or arbitrator intervention. However, FINRA believes it is important to address the industry concern that firms with sufficient capital to pay arbitration awards should not be required to produce insurance information automatically in every arbitration case. For this reason, FINRA is proposing to require a party seeking the production of insurance information to expressly request that an opposing party produce insurance information. FINRA believes that few claimants will request insurance information from well-capitalized firms.

Specifically, the Item would require firms and associated persons, upon request, to produce documents sufficient to provide details concerning the coverage and limits of any insurance policy regarding a named party under which any third-party insurance carrier might be liable to satisfy in whole or in part an award issued by an arbitrator in the subject arbitration proceeding or to indemnify or reimburse a party for payments made to satisfy an award. The Item would state that it may be prejudicial for arbitrators to be given information related to the coverage or lack of coverage by liability insurance. FINRA will train arbitrators to address potential prejudice by providing training materials on ODR's webpage and publications including *The Neutral Corner*. Any party wishing to submit evidence at a hearing relating to insurance must demonstrate to the arbitration panel that: (1) there are extraordinary circumstances warranting admission of the insurance

information; or (2) the existence of an insurance policy is directly related to the dispute outlined in the statement of claim. The party must seek express authorization from the arbitration panel to submit the evidence.

Even though FINRA would require production only upon request, the presence of the Item in the Document Production List would alert arbitrators that insurance information is a typical type of information that parties use to prepare in an arbitration proceeding. Adding the Item might result in fewer customer motions to compel production of insurance information and more consistent arbitrator rulings on the subject of insurance. However, since arbitrators only make rulings when firms or associated persons dispute discoverability, there also may be fewer instances in which arbitrators are exposed in any way to issues related to insurance.

Economic Impact Assessment

A. Regulatory Need

Insurance information describing the policies of firms and associated persons can benefit customers to determine a litigation strategy in arbitration cases. Insurance policies, however, are not presumptively discoverable. The proposed amendments would provide customers the ability to request insurance information in all arbitration cases under the Customer Code.

B. Economic Baseline

The economic baseline for the proposal is the current discovery rules and supplemental Guide contained in the Customer Code. The current discovery rules and Guide enumerate the documents that are presumptively discoverable in customer cases. The proposal would affect the parties to customer cases including customers, firms and associated persons. The proposal would also affect insurance companies and FINRA arbitrators.

Currently, customers may make a request under the Customer Code for a firm or an associated person to produce insurance information. If a firm or an associated person does not produce the information, then customers can seek an arbitrator's order for production. The lack of guidance from the Firm/Associated Persons List and the Guide, however, can lead to inconsistent arbitrator rulings regarding whether insurance documents must be produced.

Information is not available for FINRA to measure the extent to which firms and associated persons currently produce insurance information, either from responses to a customer's request or by an arbitrator's order for production, nor the outcomes when insurance information is produced.

C. Economic Impact

Under the proposed amendments, the insurance information of a firm or an associated person would be presumptively discoverable, if requested, in all customer cases. The proposed amendments would therefore increase the number of cases in which a firm or an associated person produces the information.

The benefits of the proposed amendments accrue primarily to claimants in arbitration cases. Insurance information can provide valuable information to a claimant when determining a litigation strategy. By 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. Insurance information can be particularly important during settlement discussions when the ability of a firm or an associated person to pay an award is otherwise less certain. For example, when the insurance coverage of a firm or an associated person is not known and their ability to pay an award is less certain, then a customer may have difficulty determining whether to settle a claim and for what amount. In this instance, a customer may be more likely to settle a claim for a lesser amount to ensure some monetary compensation for damages. The discovery of insurance information, therefore, could increase the ability of customers to determine a litigation strategy to maximize the monetary compensation they could expect to receive.

The proposed amendments would also increase the consistency and efficiency of the arbitration forum. Insurance information would be presumptively discoverable in all customer cases upon request. Customers would seek an arbitrator's order for production in fewer cases and, therefore, reduce the forum fees associated with the requests.⁷

Under the proposed amendments, firms and associated persons could incur additional costs associated with arbitration. Firms and associated persons that would otherwise not have provided the information would now have exposure to the risk that the opposing party could leak the information and prejudice the arbitrators. The proposed amendments, however, would restrict the ability of parties to submit evidence relating to insurance, thereby reducing the possibility that arbitrators could be prejudiced.

The proposed amendments could also increase the use of policies by firms and associated persons when customers receive monetary compensation for damages. An increase in payout by insurance companies could result in an increase in premiums, reducing the incentive for firms and associated persons to purchase coverage. Although customers could also increase their claim amount in response to knowledge of insurance coverage, FINRA staff believes that arbitrators would continue to determine monetary awards based on actual damages.

Customers would request insurance information if they believe the information is important to their litigation strategy. For example, customers could be more likely to request insurance information from less capitalized or smaller firms. Customers filed 4,811 claims in arbitration against firms and associated persons in 2016 and 2017. FINRA staff is able to identify 377 cases (8 percent) where the claim amount was greater than the excess net capital of a firm named as a respondent. The majority (3,958 or 73 percent) of the firms named as a respondent were either large or mid-sized, whereas the remaining firms (1,459 or 27 percent) were small.⁸

Customers could also be more likely to request insurance information from firms or associated persons with multiple arbitration claims. Although FINRA does not publish information on open cases, customers could become aware of other arbitration cases involving a firm or associated person by searching for concluded cases on FINRA's Awards Online database or by searching for the firm or associated person in BrokerCheck.⁹ For example, among the 4,811 cases customers filed in 2016 and 2017, 3,804 (79 percent) of the cases had as a respondent a firm or an associated person who was also a respondent to a case that closed within the previous three months and that resulted in either (1) a settlement or (2) a monetary award in which the firm or associated person was partially or fully liable.¹⁰

D. Alternatives Considered

An alternative to the proposed amendments is the automatic production of insurance information by a firm or an associated person. However, evidence of insurance is less valuable to claimants when the respondent firm is self-insured and highly capitalized. FINRA believes that relative to the proposed amendments, this additional benefit to customers would not be commensurate to the additional costs to firms to produce the information in all cases.

Request for Comment

FINRA is interested in receiving comments on all aspects of the proposed amendments. In particular, FINRA requests comment on the following:

1. The proposed amendments provide for the production of documents sufficient to provide details concerning coverage and limits of any insurance policy under which any third-party insurance carrier might be liable to satisfy in whole or in part an award. What type of documents should a party produce in order to comply with this requirement? What information contained in the documents, if any, should a party be allowed to redact before production to the other parties in the arbitration proceeding?
2. The proposed amendments provide that a party must seek express authorization from the arbitration panel to submit evidence to the panel relating to insurance information. Under FINRA Rule 12212 (Sanctions), the arbitrators would be permitted to sanction

- a party for providing evidence of insurance information to the panel without seeking express authorization to do so. Should FINRA take any additional steps relating to sanctions if a party provides insurance information to the arbitration panel without express authorization? What steps should FINRA consider taking?
3. What other rule requirements, if any, should FINRA consider to address a party's submission of insurance information to the arbitration panel without express authorization?
 4. Are there any material economic impacts, including costs and benefits, to customers, firms or associated persons that are associated specifically with the proposed amendments? If so: a) What are these economic impacts and what are their primary sources? b) To what extent would these economic impacts differ by business attributes, such as size of the firm or differences in business models? c) What would be the magnitude of these impacts, including costs and benefits?
 5. Are there any expected economic impacts associated with the proposed amendments not discussed in this *Notice*? What are they and what are the estimates of those impacts?

Endnotes

1. Persons submitting comments are cautioned that FINRA does not redact or edit personal identifying information, such as names or email addresses, from comment submissions. Persons should submit only information that they wish to make publicly available. *See Notice to Members 03-73* (November 2003) (Online Availability of Comments) for more information.
2. *See* SEA Section 19 and rules thereunder. After a proposed rule change is filed with the SEC, the proposed rule change generally is published for public comment in the *Federal Register*. Certain limited types of proposed rule changes take effect upon filing with the SEC. *See* SEA Section 19(b)(3) and SEA Rule 19b-4.
3. *See* FINRA Rule 12506 (Document Production Lists). The Discovery Guide is available at www.finra.org/sites/default/files/ArbMed/p394527.pdf.
4. The Task Force, which was composed of individuals representing a broad range of interests in securities dispute resolution, issued a report in December 2015, and action has been taken on most of its recommendations. More information about the Task Force, its recommendations and related status updates can be found at www.finra.org/arbitration-and-mediation/finra-dispute-resolution-task-force.
5. *See* Federal Rules of Civil Procedures, Rule 26 – Duty to Disclose: General Provisions Governing Discovery.
6. *See* FINRA Rule 12507 (Other Discovery Requests), which provides that parties may request additional documents or information from any party by serving a written request directly on the party.

7. Parties would incur fewer forum fees relating to these requests for production. The panel determines which party or parties pay the forum fees associated with its rulings. Arbitrators would also receive less honorarium to decide these requests.
8. The definition of firm size is based on Article 1 of the FINRA By-Laws. A firm is defined as “small” if it has at least one and no more than 150 registered persons, “mid-size” if it has at least 151 and no more than 499 registered persons, and “large” if it has 500 or more registered persons. In 289 of the 377 cases (77 percent) at least one of the firms with excess net capital less than the initial claim amount was small.
9. A customer’s counsel might also become aware of similar cases through their own caseload involving a firm or associated person, or through contact with other claimants’ counsel.
10. In 3,210 of the 3,804 cases (84 percent), FINRA staff is able to identify at least one of the firms as large or mid-size, and in 903 of the 3,804 cases (24 percent) FINRA staff is able to identify at least one of the firms as small. In a small number of cases (14) the total liability of the firm from the previous monetary awards was greater than its excess net capital.

Attachment A

Proposed new language is underlined.

DISCOVERY GUIDE DOCUMENT PRODUCTION LISTS

LIST 1

Documents the Firm/Associated Persons Shall Produce in All Customer Cases

* * *

23) (a) If requested, the firm/associated persons shall produce documents sufficient to provide details concerning the coverage and limits of any insurance policy under which any third party insurance carrier might be liable to satisfy in whole or in part an award issued by an arbitrator in the subject arbitration proceeding or to indemnify or reimburse a party for payments made to satisfy an award.

(b) It may be prejudicial for arbitrators to be given information related to the coverage or lack of coverage by liability insurance. Therefore, any party wishing to submit evidence at a hearing relating to insurance must demonstrate to the arbitration panel that: (1) there are extraordinary circumstances warranting admission of the insurance information; or (2) the existence of an insurance policy is directly related to the dispute outlined in the statement of claim. The party must seek express authorization from the arbitration panel to submit the evidence.

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