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September 21, 2018

Via E-Mail to pubcom@finra.org

Jennifer Piorko Mitchell
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 18-22 (Discovery of Insurance Information in Arbitration)

Dear Ms. Mitchell:

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on Notice 18-22 (the "Notice" or the "Proposal").[2] The Proposal would amend the Discovery Guide's Firm/Associated Person Document Production List to require firms and associated persons, upon request, to produce documents concerning third-party insurance coverage in a customer arbitration proceeding. We respectfully submit the following comments and recommendations for your consideration.

Insurance information generally has no relevance or probative value to the case.

As a general matter, insurance policies and coverage have no relevance or probative value to the issue of liability or the appropriate amount of damages in any given case. They are merely an internal risk transfer mechanism purchased by the firm. As the Notice correctly points out, insurance information is generally only useful for purposes that have nothing to do with the merits of the case itself.

[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate on legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

[2] FINRA Regulatory Notice 18-22, available at https://www.finra.org/industry/notices/18-22.

The Notice identifies two such purposes: to allow a claimant to assess a respondent's ability to pay the highest possible settlement amount or prospective arbitration award; and to allow a claimant to amend his or her claim to fit within the insurance coverage. The latter practice is questionable at best and abusive at worst, certainly from an insurance company's perspective, particularly where the actual facts of the case become distorted or lost in the exercise of reframing objective reality to meet the requirements of an insurance policy.

Moreover, the existence of potentially applicable insurance coverage is not probative of issues of liability on the part of respondent, even if the adequacy of the capitalization of the respondent to satisfy an award may be at issue. As discussed below, the panel gaining awareness of such coverage can be highly prejudicial to an insured respondent, and such prejudice may infiltrate later hearings of similar claims against even *uninsured* respondents.

Insurance information can be highly prejudicial to a firm or associated person.

Although insurance information generally has no relevance or probative value to the types of cases brought in FINRA Dispute Resolution, it can be highly prejudicial to a firm or associated person if such information is shared with the adjudicator(s). The adjudicators may inaccurately or improperly view such information as proof that the respondent has the ability to pay a substantial award, regardless of the merits, or the appropriate measure of damages, in the case.

Panels that are presented with insurance policies cannot "unsee" them and may be prone to considering the prospect of available coverage in determining whether to enter an award at all. In an instance where a panel is inclined to reach a compromise decision or "split the baby" in issuing an award, if it believes a respondent has coverage, the panel may be inclined to make an award on the faulty premise that because the award will not be funded directly by the respondent, the award will not affect the respondent. That is incorrect because any award against an insured (1) affects the risk rating of the insured/respondent and therefore drives increases in premiums for other/renewal policies and (2) affects actuarial determinations of risk for similarly situated insureds/other industry members as well as the corresponding policy premiums.

There is also a risk that where the panel is aware of potential coverage, its award may be greater than it otherwise would be if the amount of the award aligns with the coverage limits instead of the actual damages at issue in the case. This risk is particularly acute where a compromise award is issued. Consideration of the availability of insurance coverage therefore risks inflated awards which if used as a point of reference/precedent in turn will affect the size of awards issued in other cases, including ones where the respondents are self-insured.

The admissibility standard set forth in the Proposal fails to adequately recognize and mitigate these risks. The Proposal's approach to *discoverability* versus *admissibility* is also inconsistent with the legal and policy distinctions between the Federal Rules of Civil Procedure (which allow the discovery of applicable insurance policies)[3] and the Federal Rules of Evidence (which explicitly prohibit the

[3] We note that FINRA arbitration was not designed or intended to model federal civil litigation. Instead, it was intended to be more efficient and streamlined (i.e., less time consuming and expensive). Accordingly, the presumptive discovery of

introduction of the existence of a potentially applicable insurance policy into evidence). That is, the Proposal does not provide an adequate, counterbalancing, evidentiary restriction, such as that contained in Federal Rule of Evidence 411.[4]

Under the Federal Rules of Evidence, the existence or absence of insurance coverage for the claim at issue is presumptively not admissible. *See* Fed. R. Evid. 411. Evidence of insurance has only been admitted under exceptional circumstances. In addition, the federal court system's use of highly trained judges, state-licensed lawyers presenting the cases, and the availability of sanctions for abuses, further protect against the potential for prejudice against a firm whose insurance policies are admitted.

In FINRA arbitration, however, there would appear to be a higher likelihood that the arbitration panel would be exposed to a firm's insurance information either in connection with a discovery dispute over it, or because it was leaked to the arbitrators. The potential for permissive sanctions under FINRA Rule 12212 would be inadequate to curb this behavior or cure the attendant prejudice of the panel being exposed to potentially applicable coverage. Once exposed, given the prevalence of lay persons as arbitrators, the distinction between relevance and admissibility, and the understanding of the potential for prejudice, would largely be lost, resulting in potentially substantial and incurable harm to the insured respondent.

In addition, the receipt by the panel of evidence of insurance would conflict with decisional law that prohibits such evidence from being admitted or considered. *See*, *e.g.*, *Ventura v. Kyle*, 825 F.3d 876, 886 (8th Cir. 2016) ("It was utterly repugnant to a fair trial or a just verdict for the jury to hear that the damages sued for will be taken care of by an insurance company… [I]t has been almost universally held that the receipt of such evidence constitutes prejudicial error sufficient to require reversal." (citation omitted)). Consequently, an award entered in an arbitral proceeding in which the arbitrators received evidence of insurance would be subject to vacatur by a court on the grounds that the panel's receipt of such evidence constituted manifest disregard of the law and/or exceeded the power of an arbitrator. In order to protect the integrity of awards entered by FINRA arbitration panels, insurance information should be deemed presumptively prejudicial and should only be disclosed to arbitrators under the limited circumstances detailed in the Recommendations below.

Insurance information offers no assurance of eventual coverage or payment.

Related to the prejudice point above, it is frequently the case that the mere existence of insurance coverage offers very little assurance, if any, that a policy will ultimately pay-out an arbitration claim, given the plenitude of policy exclusions, exceptions, limits, coverage determinations, etc. Further, coverage is not likely to be allowed until after an award is issued, but the issuance of an award does not of itself secure coverage. To the contrary, carriers will insist upon the opportunity to examine the entire record of a hearing and will use facts presented within it to assert defenses to coverage. In effect,

insurance coverages in federal litigation is neither a logical nor persuasive argument for imposing the same requirement in FINRA arbitration.

[4] *Compare* the Notice (which states "it may be prejudicial for arbitrations to be given information related to coverage") *with* Fed. R. Evid. 411 (which states "evidence that a person was or was not insured against liability is not admissible").

evidence presented at the hearing could operate to defeat coverage notwithstanding any effort by claimant to "plead into coverage" in the statement of claim.

According to the Notice, firms would be required to produce "details concerning the coverage and limits of any insurance policy" which "might be liable" to satisfy an arbitration award. Making such a determination based on the Statement of Claim and other information available at the time of discovery, however, would be practically difficult if not impossible. As a result, firms would be essentially required to grossly overproduce insurance coverages, the vast majority of which would never as a practical matter cover or pay an arbitration award.

- In terms of subject matter, for example, claimants frequently include the full panoply of claims (i.e., fraud, theft, misrepresentation, etc.) even if the elements of these claims are not actually present under the facts of the case. The typical overbreadth in pleading would in turn require firms to unnecessarily produce insurance coverages (e.g., theft, fidelity bond, directors and officers, umbrella, etc.) that rarely if ever cover or pay arbitration awards.

- In terms of policy limits, virtually all insurance policies have retentions/deductibles. Claimants, however, often significantly overinflate the value of their case (e.g., casting a $50K loss as a $10M claim). Such claim inflation would require firms to unnecessarily produce insurance policies with high deductibles that would almost certainly never apply.

- In terms of coverage determinations, at the time an arbitration award is made, many insurers would not have provided an opinion on whether their policy would apply. Nor would they have determined whether any coverage exclusions apply (e.g., for criminal acts, intentional fraud, etc.).

RECOMMENDATIONS

Requests for Insurance Information

The underlying premise of the Proposal appears to be to provide a mechanism to verify the financial soundness and ability of a firm to pay an arbitration award. Where there is no demonstrable concern about the financial soundness of a firm, however, the requirement to produce insurance coverages is overbroad and unduly burdensome. Most well-capitalized firms have been in business for a significant period of time and have always paid their arbitration awards. These firms are not a legitimate concern and should not be burdened with an unnecessary insurance production requirement.

The Notice suggests that these well-capitalized firms will not be burdened with the new proposed requirement because "few claimants will request insurance information from well-capitalized firms." That is cold comfort. If claimant's counsel is empowered to request insurance information, why would they not? It wouldn't cost them anything; it would force the respondent firm to expend time and resources (sometimes a goal in and of itself in the adversarial process); and it might be useful in other ongoing or future cases.

The marginal, if any, benefit to claimants of discovering all possible insurance coverages would be far outweighed by the substantial costs to well-capitalized firms of reviewing and producing such documents, engaging in discovery disputes, and suffering potential prejudice in the arbitration proceeding as a result.

Regardless, and in addition, it would be inappropriate for FINRA to impose a new regulatory obligation that gives customer claimants the sole and unfettered discretion to impose an unnecessary discovery burden on well-capitalized firms. For all the foregoing reasons, we recommend as follows:

Recommendation. A request for insurance information should be supported by a showing of good cause that the ability of a respondent to pay an arbitration award is reasonably in question, including, without limitation, a showing that the respondent has a history of not paying arbitration awards.

Recommendation. A firm should be allowed to satisfy a request for insurance information upon representing that it self-insures, or has captive insurance, for arbitration claims.

Recommendation. The Proposal should explicitly state and clarify that it applies only to third party insurance coverages and does not apply to firms that rely upon self-insurance or captive insurance to satisfy their arbitration awards.

Content of Insurance Information

As discussed above, the Proposal would require the production of "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 … an award…."

Recommendation. The Proposal should not require production of complete policies but should provide firms with the flexibility to provide summaries of policies that highlight the subject matter of coverage, policy deductibles and policy limits; alternatively, firms should also be allowed to provide certificates of coverage, or declaration pages.

Recommendation. The Proposal should explicitly permit firms to maintain the confidentiality of their negotiated premiums, exclusions, and other policy terms that confer a competitive business advantage. Likewise, the Proposal should explicitly permit firms to maintain the confidentiality of information belonging to a non-party (e.g., an insurance policy belonging to a predecessor-in-interest firm).

Avoiding Prejudice

Proposed Document Production List 1, Item 23(b), explicitly states that "It may be prejudicial for arbitrators to be given information related to the coverage or lack of coverage by liability insurance." Yet, inexplicably, Item 23(b) provides only very narrow protection against such prejudice for "submit[ting] evidence at a hearing relating to insurance." Item 23(b) should be appropriately expanded to provide much broader protection against prejudice by strictly

limiting the provision of information about insurance to arbitrators at any point in the arbitration process.

In addition, as explained above, insurance policies and coverage usually have no relevance to the issue of liability or the appropriate amount of damages in any given case, nor are they probative of either. Yet, Item 23(b) would expose arbitrators to insurance information if the claimant could show "the existence of an insurance policy is directly related to the dispute outlined in the statement of claim." This provision risks improperly equating the newly proposed *discoverability* standard with what should otherwise be an exceptionally stringent *admissibility* standard. That runs directly contrary to the established procedure in federal court, cannot be what FINRA intended, and would expose arbitrators – to the detriment of the respondent firm – to all insurance information provided in every case. Item 23(b) should be appropriately amended to bar the admission or disclosure of insurance information to arbitrators unless the claimant can show it is directly relevant to an issue in the case.

Recommendation. Newly proposed Item 23(b) should be revised to address the two significant concerns identified immediately above by incorporating the following bold underlined text:

> 23)(b) It ~~**may**~~**shall be presumed to** 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**, or to disclose information to arbitrators related to the coverage or lack of coverage by liability insurance at any point in the arbitration process,** must demonstrate to the panel that: (1) there are extraordinary circumstances warranting admission **or disclosure** of the insurance information; or (2) the existence of an insurance policy is directly ~~**related**~~**relevant** to the dispute outlined in the statement of claim **(*other than* for purposes of showing that such insurance may be available to satisfy an award)**. The party must seek **and obtain** express authorization from the arbitration panel **prior** to submit**ting** the evidence **or disclosing the information at any point in the arbitration process**.

Training of and Guidance for Arbitrators

In the Proposal, FINRA states that it "will train arbitrators to address potential prejudice by providing training materials on ODR's webpage and publications including *The Neutral Corner*." We believe that arbitrator training and guidance on this topic will be essential as we anticipate that plaintiffs' counsel will be aggressive in seeking to provide insurance information to panels in order to prejudice respondent firms. We believe the Proposal needs to go further to avoid such prejudice.

Recommendation. In order to avoid undue prejudice to respondents, and to avoid rendering arbitration awards susceptible to vacatur for manifest disregard of the law and/or exceeding the power of an arbitrator, the Proposal should explicitly provide that arbitrators

should follow a presumption in favor of granting protective orders disallowing disclosure of insurance-related information to the panel.

Recommendation. The Proposal should explicitly provide that arbitrators should follow a presumption in favor of imposing stiff sanctions under FINRA Rule 12212 against a party whose request for leave to disclosure insurance-related information to the panel is denied, or who disclosed insurance information to the panel or an arbitrator without obtaining prior express authorization to do so.

* * *

If you have any questions or would like to further discuss these issues, please contact the undersigned.

Sincerely,

Kevin M. Carroll
Managing Director and
Associate General Counsel

cc: ***via e-mail to:***
Robert L.D. Colby, Chief Legal Officer, FINRA
Richard W. Berry, Executive Vice President and Director, FINRA-DR
Kenneth L. Andrichik, Senior Vice President and Chief Counsel, FINRA-DR
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