Stepping Into the Ring Against the SEC and FINRA: Sometimes It Pays to Duke It Out Against the Regulators

*By Brian L. Rubin and Jae C. Yoon**

Faced with the possibility of litigating against the Securities and Exchange Commission (SEC) or the Financial Industry Regulatory Authority (FINRA), many broker-dealer firms, registered representatives, and associated persons choose to settle rather than step into the ring against the regulators on their home turf under their rules, with their considerable resources,[1] their home-town scoring judges (or refs, if you prefer), and their weighty reputations and impressive win-loss records. Settlement is often attractive because it provides closure and allows the subject of the investigation to avoid the uncertainty of fighting the regulators. But the results of this study—which analyzes litigated enforcement cases from October 2010 through March 2012[2] (the "Study Period") where firms and individuals were charged with violating SEC and FINRA statutes, rules and regulations—demonstrate that, in certain circumstances, the underdog still can prevail.

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FINRA was created in July 2007 through the consolidation of NASD and NYSE Member Regulation. According to FINRA, it oversees approximately 4,400 brokerage firms and approximately 630,000 registered representatives. See http://www.finra.org/AboutFINRA/.

Methodology

> Fear is the greatest obstacle to learning in any area, but particularly in boxing. For example, boxing is something you learn through repetition. You do it over and over and suddenly you've got it. . . ..However, in the course of trying to learn, if you get hit and get hurt, this makes you cautious, and when you're cautious you can't repeat it, and when you can't repeat it, it's going to delay the learning process.[3]
>
> Cus D'Amato

In our area of learning, respondents are not able to learn about litigating against the SEC or FINRA through repetition. One hit in a litigated proceeding and a respondent could get knocked out of the securities industry. To address this need to learn through other means, Sutherland began studying litigated proceedings to look for trends. Since 2005, Sutherland has conducted a study of litigated disciplinary proceedings brought by FINRA (formerly NASD) against firms, registered representatives, and associated persons.[4] Since 2008, Sutherland also has analyzed administrative proceedings brought by the SEC against the same types of respondents. The initial and appellate decisions in these administrative proceedings are publicly available on each regulator's website, and each was analyzed to determine the number of respondents, the number of charges brought, whether a respondent was represented by counsel, the sanctions sought by the staff, and what charges were dismissed, among other things.

The current study analyzes three SEC administrative law judge (ALJ) decisions issued between October 1, 2010, and March 31, 2012, involving seven respondents and 14 total charges, and four Commission decisions issued during that period with respect to seven respondents and 12 charges. The study analyzes 43 FINRA Hearing Panel decisions issued between October 1, 2010, and March 31, 2012. These cases involved 49 respondents and 115 total charges. The study also analyzed 25 decisions by the National Adjudicatory Council (NAC) considering the appeals of 37 respondents and 15 SEC Commission decisions considering the appeals of 22 FINRA respondents.[5]

The Results of the Study

I. ALJ and Hearing Panel Findings of Violations

> In boxing, everybody has their favorites.[6]
>
> Thomas Heams

One reason respondents fear litigating against the regulators is the

perception that the staff has an advantage because they and hearing officers are members of the same "club." While the hearing officers are not necessarily members of the same fight club or boxing gym (as far as we know), the results of the study show that the staff of the SEC and FINRA have a strong win-loss record against respondents. However, the study also shows that respondents continue to succeed in getting charges dismissed, including fraud charges.

A. SEC

SEC administrative proceedings are conducted before an ALJ, who is not a Commission employee, but who hears the proceedings pursuant to authority delegated by the Commission.[7] The ALJ has the authority to, among other things, rule on evidentiary and discovery matters and generally "regulat[e] the course of a proceeding and the conduct of the parties and their counsel."[8] The ALJ also applies a preponderance of the evidence standard.[9] At the conclusion of the hearing, the ALJ drafts the initial decision.[10]

During the Study Period, only seven respondents litigated against the SEC, and none convinced the ALJ to dismiss any charges. However, SEC respondents have had greater success in previous years, obtaining dismissal of 25.3% of charges.[11]

B. FINRA

In FINRA proceedings, the Hearing Officer is a FINRA employee.[12] FINRA hearings are conducted before a Hearing Panel with two current or former industry members and the Hearing Officer, who has the authority to hold pre-hearing and other conferences and resolve procedural and evidentiary matters, such as discovery requests, among other things.[13] The Hearing Panel applies a preponderance of the evidence standard when determining whether violations have occurred.[14] At the conclusion of the hearing, the Hearing Officer drafts the initial decision.[15]

During the Study Period, FINRA Hearing Panels considered 112 charges against member firms and individuals. These respondents convinced Hearing Panels to dismiss 16 charges, a success rate of 14.3%.[16] Interestingly, FINRA respondents' success rate in getting charges dismissed during the Study Period was nearly double the rate for the two years prior to the Study Period, when respondents were able to obtain dismissals of 13 charges out of 178, or 7.6%.[17] Although FINRA staff is not required to establish fraud under a more stringent evidentiary standard, they must still establish scienter,[18] and respondents were more successful in obtaining dismissal of fraud charges than they were generally.[19]

In 2011, the five categories of charges in which FINRA obtained the greatest aggregate amount of fines through disciplinary actions (which

includes not only litigated actions but also settlements) were the following: advertising, auction rate securities, suitability, and improper form U4, U5 and Rule 3070 filings.[20] An analysis of the litigated cases during the Study Period demonstrates that FINRA generally has had success in proving those categories of charges. FINRA staff succeeded in proving all five of its advertising charges and all nine charges relating to Forms U4 and U5. With respect to suitability, FINRA staff succeeded in proving three of five charges. However, FINRA successfully proved only one of four charges in its only litigated case involving auction rate securities during the Study Period.

II. Sanctions[21]

Sure, there have been injuries and deaths in boxing—but none of them serious.[22]

Alan Minter

The regulators have the authority to score knock-out blows in administrative proceedings. For example, a temporary suspension may significantly and permanently affect an individual's career opportunities in the industry. The results of the study indicate that, although litigation can be costly, firms and individuals should consider fighting the regulators if they believe a particular sanction proposed by the staff is not supported by the facts or law.

A. SEC

The SEC has broad enforcement authority under the federal securities statutes, and for firms and registered representatives who violate the Securities Exchange Act of 1934, the SEC may impose a variety of sanctions including bars[23] and civil penalties.[24]

SEC respondents convinced ALJs to impose lower monetary sanctions 28.6% of the time during the Study Period (2 of 7). In contrast, from October 1, 2008 through September 30, 2010, ALJs lowered monetary sanctions 50% of the time (5 of 10). But unlike FINRA Hearing Panels, since October 1, 2008, no ALJ has ordered a higher monetary penalty than that sought by the Staff.

With respect to suspensions and bars, none of the seven SEC respondents in cases from the Study Period succeeded in convincing the ALJ to order a sanction less than that sought by the SEC staff (although no ALJ imposed a higher sanction than was sought by SEC Staff). In contrast, during the prior two years, respondents were successful 30% of the time (3 of 10).

B. FINRA

FINRA Hearing Panels can censure, fine, suspend, expel, bar, impose a temporary cease and desist order, or "impose any other fit-

ting sanction."[25]

FINRA respondents convinced Hearing Panels to reduce the proposed monetary sanction a third of the time during the Study Period (3 of 9). When fines were reduced, the proposed fine ranged from $15,000 to $30,000, and averaged $21,250. The amount ordered ranged from $5,000 to $20,000, and averaged $9,250 (a reduction of approximately 56%). FINRA respondents were more successful during the Study Period than in prior years, when their success rate was approximately 27%.[26] Three FINRA Hearing Panels ordered fines greater than those requested by FINRA staff during the Study Period.[27]

Where cases specified the length of suspension sought by FINRA staff or specified that the staff sought a bar, respondents succeeded 50% of the time in obtaining a shorter suspension or in having a bar reduced to a suspension (6 of 12). FINRA respondents thus were more effective recently than during the two years prior to the Study Period, where they succeeded only 36.8% of the time (14 of 38). When FINRA staff sought a suspension of a set amount of time (as opposed to a complete bar) during the Study Period, respondents convinced the Hearing Panel to reduce the suspension 37.5% of the time (3 of 8). However, the Hearing Panel did increase the suspension 25% of the time (2 of 8). When FINRA staff sought a complete bar from the industry, respondents were much more successful, as 75% of them convinced a Hearing Panel to impose a lesser sanction (3 of 4).

III. Appeals

> Getting hit motivates me. . . . A fighter takes a punch, hits back with three punches.[28]
>
> Roberto Duran

After receiving an unfavorable decision, a respondent may want to hit back by filing an appeal (but not three times). The study finds that respondents must carefully weigh the risk of having a greater sanction imposed against the possibility that an appeal will reduce sanctions or result in dismissal of the proceeding altogether.

A. SEC

In SEC administrative proceedings, either party may file a petition for review[29] or the Commission also may independently seek review of the ALJ's initial decision.[30] The Commission's consideration of an ALJ's initial decision is compulsory only in specific circumstances.[31] SEC respondents may appeal the Commission's decision either to the United States Circuit Court of Appeals for the circuit in which the respondent resides or has its principal place of business, or to the D.C. Circuit Court of Appeals.[32]

Six SEC respondents appealed ALJ initial decisions, and one re-

spondent cross-appealed to the Commission. Of those, two respondents were successful in getting the charges against them dismissed, including the respondent who cross-appealed from the ALJ's initial decision.[33] Another respondent was successful in having his sanction reduced (from a complete bar to a bar with right to reapply after two years). The Commission increased the sanctions for three respondents, including in one instance where the SEC staff cross-appealed the ALJ decision. In contrast, in FY 2009-2010, no respondents succeeded in getting the charges dismissed, one-third were successful in getting reduced sanctions (3 of 9), and sanctions were increased 22.2% of the time (2 of 9). Four SEC respondents appealed SEC decisions to U.S. Courts of Appeals, which affirmed each of the decisions.

B. FINRA

Either party may appeal a FINRA Hearing Panel decision to the NAC, or any member of the NAC may call the decision for review.[34] Unlike the Commission, the NAC does not have the discretion to decline consideration of an appeal. A NAC decision may be appealed only by respondents, and the appeal is considered by the Commission. FINRA respondents may appeal the Commission's decision either to the United States Circuit Court of Appeals for the circuit in which the respondent resides or has its principal place of business, or to the D.C. Circuit Court of Appeals.[35]

No FINRA respondent was successful before the NAC in having all findings of violations reversed during the Study Period, but 10.8% were able to get one or more findings of violations reversed (4 of 37). FINRA respondents had greater success during the two years prior to the Study Period when 16.7% of respondents were successful in having all findings of violations reversed (6 of 36). Although only 10.8% of FINRA respondents were able to obtain a reversal on at least one violation during the Study Period, 29.7% of respondents succeeded in convincing the NAC to reduce the sanctions imposed by the Hearing Panel (11 of 37). But like the Hearing Panel, the NAC demonstrated that it is willing to increase sanctions when it believes appropriate; it imposed greater sanctions for 32.4% of the respondents (12 of 37). Of the eight cases where sanctions were increased, FINRA Enforcement staff had also appealed the Hearing Panel's decision in one case, and in another case, the NAC called the case for review.

Approximately 86% of respondents' appeals of NAC decisions to the SEC were either dismissed without briefing or resulted in affirmed sanctions (19 of 22).[36] Of the three remaining cases, one respondent was able to obtain reduced sanctions, one respondent had his case remanded to FINRA for reconsideration of sanctions, and one respondent obtained a complete dismissal. Five FINRA respondents appealed SEC decisions to the U.S. Courts of Appeals, which affirmed

the decision of the SEC in each instance.

IV. The Timing of Litigation

When things are tough, you fight one more round.[37]

James J. Corbett

Litigating a case may take months or years to resolve (after an investigation that itself may have taken months or years to conduct). Some respondents prefer settling to avoid these delays and to put the matter behind them. Others may choose to litigate to clear their names, while taking advantage of the fact that they can typically work and earn a living while the litigation is pending.

A. SEC

For SEC ALJ initial decisions issued during the Study Period, the time between the filing of the OIP and the ALJ Initial Decision averaged just over 10.5 months. Appeals similarly take a substantial amount of time. Respondents in SEC decisions on appeal from ALJs waited on average 13 months. Unfortunately, for SEC respondents, an appeal to the appropriate federal court of appeals does not operate as an automatic stay of the sanction imposed by the SEC.

B. FINRA

For FINRA Hearing Panel decisions, the time between the filing of the complaint and the rendering of the Hearing Panel decision averaged just over 14 months. When appealed, Hearing Panel decisions are stayed and respondents can therefore continue to work while appeals to the NAC are pending. NAC decisions issued during the Study Period were issued approximately 19 months after the Hearing Panels' decisions. Appeals to the SEC, which stay the effectiveness of any FINRA-imposed sanction except for a bar or expulsion, took approximately 13 months. Thus, for FINRA respondents, the time between the filing of a complaint and the issuance of an SEC decision averages approximately three years and 10 months.

V. Case Study

The American Funds Distributors, Inc. (AFD) proceeding, in which the Commission dismissed the action altogether (on a two to one vote), is a particularly notable example of a firm choosing to litigate rather than settle. FINRA alleged in its enforcement action that AFD's use of directed brokerage payments, a practice where AFD directed trades through brokerages' trading desks as a reward for selling funds to retail clients where AFD was the principal underwriter and distributor of those funds. Over 20 other firms that also engaged in directed brokerage payment activities decided to settle rather than to fight FINRA, resulting in FINRA obtaining more than $50 million in settle-

ments from those firms.[38] AFD decided to fight, arguing before the Hearing Panel that, although the practice in question was expressly prohibited in a later amendment, the version of the rule in effect during the relevant period did not prohibit its conduct. The Hearing Panel imposed a $5 million fine (FINRA staff actually sought a $98 million fine) and the NAC affirmed.[39] In addition to finding that AFD's conduct was intentional, and not merely negligent, the NAC stated:

> . . . even assuming arguendo that AFD's practices were widespread, this fact would not mitigate AFD's misconduct. Failure to follow FINRA's rules because "everyone else in the industry is doing it" is not a mitigating factor. It is well established that industry-wide misconduct is no defense when a firm violates FINRA's rules. It is the responsibility of each FINRA member to follow FINRA's rules, and for FINRA to enforce its rules.[40]

AFD appealed to the SEC, arguing that "in the event its practices ran afoul of the Rule, it was a consequence of ambiguity in the Rule's language and inadequate guidance from NASD as to the Rule's meaning."[41] The SEC agreed, stating that "[u]nder all of the circumstances, including our concern about uncertainty resulting from the language of the Rule in effect during the period at issue, the fact that the 2004 Amendments clarified the extent of the Rule's prohibition, and the evidence of AFD's compliance efforts with respect to directed brokerage practices, we have determined to set aside the NASD's action."[42]

Conclusion

> The hero and the coward both feel the same thing, but the hero uses his fear, projects it onto his opponent, while the coward runs. It's the same thing, fear, but it's what you do with it that matters.[43]
>
> Cus D'Amato

As in boxing, fear is likely one emotion that respondents (or their counsel) may feel when they decide whether to fight. One way to face that fear may be to review actual cases to see how other respondents fared when they fought the SEC or FINRA. As the AFD enforcement action demonstrates, a firm can prevail even where numerous firms have decided to settle for similar conduct. Of course, as discussed above, those firms may have chosen to settle to avoid protracted litigation. (Note that the AFD complaint was filed over six years before the SEC finally dismissed the proceeding.) Overall, the study confirms that charges, including charges of fraud, can be dismissed, and that a significant percentage of respondents can obtain lower sanctions than those sought by the staff. In the end, however, the decision of how to address the fear of the regulators depends in large part on the particular facts and circumstances of each case. Thus, each respondent

must assess (among other things), the facts, the law, the precedent and what can be gained (and lost) by fighting or settling. And every respondent should take to heart the words of Muhammad Ali: "He who is not courageous enough to take risks will accomplish nothing in life."[44]

NOTES:

[1]The resources of the SEC and FINRA are vast in comparison to most of their enforcement targets. For its 2011 fiscal year, the SEC spent over $630 million on its Enforcement and its Compliance Inspections and Examinations programs. See SEC, FY 2011 Performance and Accountability Report at 149 (2011), available at http://www.sec.gov/about/secpar/secpar2011.pdf. FINRA's expenses for the calendar year 2011 were nearly $995 million. FINRA, FINRA 2011 Year in Review and Annual Financial Report at 5 (2012), available at http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p127312.pdf.

[2]The Study Period coincides with the SEC's 2011 fiscal year and the first half of the 2012 fiscal year.

[3] http://www.tysontalk.com/Media/tysonian__quotes__idea/CusQuotes.html.

[4]Sutherland's first study was titled "The House That the Regulators Built: An Analysis of Whether Respondents Should Litigate Against NASD." It was published in BNA's May 2005 Securities Regulation & Litigation Report, 2005 WL 998243 (May 2, 2005), and won the 2006 Burton Award for Legal Achievement.

[5]The cases reviewed were those in which decisions were issued during the Study Period, which are not necessarily the appeals of respondents in Hearing Panel decisions issued during the Study Period.

[6] http://www.brainyquote.com/quotes/authors/t/thomas__hearns.html.

[7]See 17 C.F.R. § 201.110 ("All proceedings shall be presided over by the Commission or, if the Commission so orders, by a hearing officer. When the Commission designates that the hearing officer shall be an administrative law judge, the Chief Administrative Law Judge shall select, pursuant to 17 C.F.R. 200.30-10, the administrative law judge to preside.").

[8]17 C.F.R. § 201.111.

[9]See *Steadman v. S. E. C.*, 450 U.S. 91, 103, 101 S. Ct. 999, 67 L. Ed. 2d 69, Fed. Sec. L. Rep. (CCH) P 97878 (1981) (noting the "Commission's longstanding practice of imposing sanctions according to the preponderance of the evidence").

[10]See 17 C.F.R. § 201.111(i) (granting ALJ authority to "prepar[e] an initial decision").

[11]SEC ALJs dismissed 23 of 91 charges from October 1, 2007, through September 30, 2010.

[12]See FINRA Rule 9231(b).

[13]See FINRA Rule 9235(a).

[14]See, e.g., Dep't of Enforcement v. Leopold, No. 2007011489301 at 5 (NAC 2012), available at http://www.finra.org/web/groups/industry/documents/nacdecisions/p125679.pdf ("Our role as an appellate body is to conduct a de novo review of cases ap-

pealed from Hearing Panel decisions to determine whether, in each instance, Enforcement has proven its allegations by a preponderance of the evidence . . .") (citation omitted).

[15]See FINRA Rule 9235(a)(7) (granting the Hearing Officer the authority to "draft[] a decision that represents the views of the majority of the Hearing Panel").

[16]The data from the Study Period and prior periods shows that successful respondents are represented by counsel. During the Study Period, pro se respondents went 0-for-27, and since January 2006, only one pro se respondent has succeeded in getting any charge dismissed.

[17]October 1, 2008, through September 30, 2010.

[18]For fraud charges, a Hearing Panel will apply a preponderance of the evidence standard and that the respondent acted with scienter. See, e.g., Enforcement v. Thomas Weisel Partners, No. 2008014621701, at 26 (OHO 2011), available at http://www.finra.org/web/groups/industry/documents/ohodecisions/p126061.pdf ("To establish that TWP violated the antifraud provisions of the securities laws and NASD rules, Enforcement must prove by a preponderance of the evidence that TWP: (i) made a material misrepresentation or omission; (ii) in connection with the purchase or sale of a security; and (iii) acted with scienter.") (internal reference omitted).

[19]The Office of Hearing Officers (OHO) dismissed two of the nine fraud charges asserted during the Study Period. In the three years prior to the Study Period, October 1, 2007 through September 30, 2010, the OHO dismissed three of 14 fraud charges.

[20]"Annual Sutherland FINRA Sanctions Survey Shows a 51% Jump in Fines in 2011," March 12, 2012, available at http://www.sutherland.com/newsevents/News__Detail.aspx?News=1276750e-5346-4135-bfc0-a7970d87db47.

[21]This section discusses only those cases where the decisions indicate a specific sanction sought by FINRA or SEC staff for a specific charge.

[22] http://www.brainyquote.com/quotes/authors/a/alan__minter.html.

[23]See 15 U.S.C.A. § 78o(b)(6)(A).

[24]See 15 U.S.C.A. § 78u-2.

[25]FINRA Rule 8310(a).

[26]In cases from October 1, 2008, through September 30, 2010, seven of 26 respondents convinced Hearing Panels to imposing a smaller monetary sanction.

[27]In one of those cases, the Hearing Panel imposed a fine of $150,000, which was double the fine requested by the staff, because it found that the respondent firm "approved the communications while essentially ignoring its own supervisory procedures designed to achieve compliance with the applicable advertising rules that, in turn, are designed to protect the investing public," and determined that "a censure and a substantially larger fine than that recommended by Enforcement are required to achieve the appropriate remedial effect of deterring [the respondent], and others, from similar misconduct." Dep't of Enforcement v. CapWest Secs. Inc., No. 2007010158001 at 16 (OHO 2011), available at http://www.finra.org/web/groups/industry/documents/ohodecisions/p126041.pdf.

[28] http://www.brainyquote.com/quotes/authors/r/roberto__duran.html.

[29]See 17 C.F.R. § 201.410(a) ("In any proceeding in which an initial decision is made by a hearing officer, any party . . . may file a petition for review of the decision with the Commission.").

[30]See 17 C.F.R. § 201.411(c) ("The Commission may, on its own initiative, order review of any initial decision, or any portion of any initial decision, within 21 days after the end of the period established for filing a petition for review pursuant to § 210.410(b).").

[31]See 17 C.F.R. § 201.411(b) (mandatory review where initial decision relates to registration of securities, suspension of trading in securities, or was decided in a case where notice and hearing were not required).

[32]See 15 U.S.C.A. § 78y(a)(1).

[33]Theodore W. Urban cross-appealed the decision of an ALJ that found that Urban (the general counsel of a broker-dealer during the relevant time) was a supervisor for purposes of liability under Sections 15(b)(4)(E) and 15(b)(6) of the Securities Exchange Act of 1934 despite also finding that Urban did not have the traditional powers of someone who supervised brokers, such as the power to hire and fire. See *In re Urban*, No. 3-13655, at 52 (ALJ Initial Decision, 2010), available at http://www.sec.gov/litigation/aljdec/2010/id402bpm.pdf (concluding that, although Urban was not responsible for hiring or terminating anyone outside of his department and "[e]ven though Urban did not have any of the traditional powers associated with a person supervising brokers . . . the case law dictates that Urban be found to be [the broker]'s supervisor"). The ALJ ultimately dismissed the proceedings against him because the Division of Enforcement failed to establish that Urban's supervision of the rogue registered representative was not reasonable. After both sides appealed, the Commission dismissed the proceedings against Urban because the Commission was evenly split on a one-to-one vote as to whether the OIP's allegations had been established. *In re Urban*, No. 3-13655 at 2, n.5 (SEC 2012), available at http://www.sec.gov/litigation/admin/2012/34-66259.pdf (noting that the initial decision of the ALJ was to be of "no effect").

[34]See FINRA Rule 9312(a)(1).

[35]See 15 U.S.C.A. § 78y(a)(1).

[36]Respondents had greater success in the two years prior to the Study Period, when approximately 73.7% of appeals were dismissed without briefing or resulted in affirmed sanctions (14 of 19).

[37] http://www.brainyquote.com/quotes/authors/j/james__j__corbett.html.

[38]See http://www.finra.org (search term "directed brokerage").

[39]Dep't of Enforcement v. American Funds Distribs., Inc., No. CE3050003 (NAC 2008), available at http://www.finra.org/web/groups/industry/@ip/@enf/@adj/documents/nacdecisions/p038418.pdf.

[40]Dep't of Enforcement, No. CE3050003 (NAC 2008) at 19 (citation omitted).

[41]In re American Funds Distribs., Inc., No. 3-13055 at 8 (SEC 2011), available at http://www.sec.gov/litigation/opinions/2011/34-64747.pdf.

[42]*In re American Funds Distribs., Inc.*, No. 3-13055 at 9-10.

[43] http://quotationsbook.com/quote/14740/.

[44] http://www.brainyquote.com/quotes/authors/m/muhammad__ali.html.