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Punishing Bad Brokers: Self-Regulation and FINRA Sanctions

Barbara Black
University of Cincinnati College of Law, barbara.black@uc.edu

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INTRODUCTION

Regulation of the broker-dealer industry by a self-regulatory organization (SRO)[1] is an integral part of the federal regulatory scheme under the Securities Exchange Act of 1934 (the Exchange Act). As a result, the Financial Industry Regulatory Authority (FINRA), the sole SRO for U.S. broker-dealers,[2] plays an important role in protecting investors, especially retail investors, and bolstering investor confidence in the securities industry and capital markets.[3] Suppose a retail investor believes that the sales representative of the brokerage firm with whom she has an account[4] (colloquially, her "broker") has abused her trust and caused her financial loss. The investor likely wants to recover her losses and to see the broker punished. FINRA, and not the U.S. Securities and Exchange Commission (the SEC), is the regulator that primarily addresses her concerns, the first through its arbitration forum[5] and the second through its disciplinary proceedings. FINRA is the "cop on the beat." In 2012 FINRA brought approximately 1500 disciplinary actions against broker-dealer firms and associated persons, imposed fines of more than $68 million, and

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* Charles Hartsock Professor of Law and Director, Corporate Law Center, University of Cincinnati College of Law. This paper was written for Brooklyn Law School's February 8, 2013, symposium on the Growth and Importance of Compliance in Financial Firms: Meaning and Implications. My thanks to Professor James Fanto for inviting me to participate. Bryan Wisecup and Christopher Jones, Corporate Law Fellows and UC Law '14, provided valuable research assistance.

1. "Self-regulatory organization" is a defined term in the Securities Exchange Act of 1934 (Exchange Act), Pub. L. No. 94-29, sec. 3(6), § 3(a)(26), 89 Stat. 97, 100 (1975) (codified as amended at 15 U.S.C. § 78c(a)(26) (2012)), and includes a national securities association registered under 15 U.S.C. § 78o-3. The Financial Industry Regulatory Authority, Inc. (FINRA), previously known as the National Association of Securities Dealers, Inc. (the NASD), is the only national securities association.

2. In 2007, the member firm regulation and enforcement functions of the New York Stock Exchange and NASD were consolidated, and the NASD changed its name to FINRA. The consolidation was intended to "streamline the broker-dealer regulatory system, combine technologies, and permit the establishment of a single set of rules and [a single set of] examiners with complementary areas of expertise [within] a single [SRO]." Self-Regulatory Organizations, Exchange Act Release No. 55,495, 2007 WL 1260858, at *9 (Mar. 20, 2007). Today FINRA describes itself as the "leading *non-governmental* regulator for all securities firms doing business with the U.S. public." *About FINRA: Leadership*, FINRA, http://www.finra.org/AboutFINRA/Leadership/ (last visited Nov. 17, 2013) (emphasis added).

3. "Our chief role is to protect investors by maintaining the fairness of the U.S. capital markets." *About FINRA: Leadership*, *supra* note 2.

4. The sales representatives are "associated persons" of the brokerage firm under the Exchange Act. 15 U.S.C. § 78c(a)(18).

5. I have previously written about the FINRA securities arbitration process and its importance to retail investor confidence. *See* Barbara Black, *Is Securities Arbitration Fair to Investors?*, 25 PACE L. REV. 1 (2004).

ordered restitution of $34 million to injured investors.[6] It expelled thirty firms, barred 294 individuals, and suspended another 549 individuals.[7] Most of FINRA's disciplinary proceedings are mundane and do not grab headlines. Consisting of a single broker accused of simple fraud, the proceedings are frequently uncontested, or if contested, the broker appears pro se.[8] Thus, FINRA's enforcement efforts do not garner the headlines that the SEC receives,[9] and there has been little scholarly interest in FINRA disciplinary proceedings.[10]

My interest in securities self-regulation and, in particular, FINRA sanctions stems from my service as a member of FINRA's National Adjudicatory Council (the NAC) from 2009–2011. The NAC is the appellate body that reviews initial decisions in FINRA disciplinary and membership proceedings.[11] Its fourteen members, consisting of seven industry representatives and seven public representatives, engage in extended discussions about the facts and circumstances of the cases that come before it, and the discussions frequently boil down to whether the misconduct was "egregious," warranting stiffer sanctions, or something less serious, sometimes expressed as "serious but not egregious." FINRA adjudicators have broad discretion in determining sanctions;[12] there is no definition of this key concept "egregious."[13] Although many NAC members

6. *About FINRA: What We Do*, FINRA, http://www.finra.org/AboutFINRA/WhatWeDo/ (last visited Nov. 17, 2013).

7. *See FINRA Statistics: Statistical Review 2008–2012*, FINRA, http://www.finra.org/Newsroom/Statistics/ (last updated July 12, 2013).

8. *See* Yin Wilczek, *FINRA Enforcement Numbers on Track to Match 2012 Record, Chief Enforcer Says*, BLOOMBERG L., http://about.bloomberglaw.com/law-reports/finra-enforcement-numbers-on-track-to-match-2012-record-chief-enforcer-says/ (last visited Nov. 17, 2013) (reporting that FINRA Chief of Enforcement says the home office continues to see a significant number of "single broker cases" involving "petty dishonesty").

9. It is reported that FINRA CEO Richard Ketchum now seeks greater visibility for FINRA and is "tracking bigger game." *See* Ben Protess, *Regulator Plans to Expand Its Focus*, N.Y. TIMES DEALBOOK (Jan. 8, 2013, 12:54 PM), http://dealbook.nytimes.com/2013/01/08/regulator-plans-to-expand-its-focus/.

10. Much of the scholarship on securities self-regulation has been written by professors at Brooklyn Law School. *See, e.g.*, NORMAN S. POSER & JAMES A. FANTO, BROKER-DEALER LAW AND REGULATION (4th ed. 2007); Roberta Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. 151 (2008). Recently, Professor James Park discussed FINRA disciplinary proceedings in *Rules, Principles, and the Competition to Enforce Securities Laws*, 100 CAL. L. REV. 115 (2012).

11. *National Adjudicatory Council (NAC)*, FINRA, http://www.finra.org/Industry/Enforcement/Adjudication/NAC/index.htm (last visited Nov. 17, 2013).

12. *March 2006 Revisions to the NASD Sanction Guidelines – FAQ*, FINRA, http://www.finra.org/industry/enforcement/sanctionguidelines/p016371 (last visited Nov. 17, 2013) [hereinafter *March 2006 Revisions*] (answer to question 7).

13. *Id.* (answer to question 17) (In determining if a violation is egregious, the adjudicators "assess the individual facts and circumstances of the case" and "also consider all relevant aggravating and mitigating factors.").

are attorneys,[14] the discussions do not generally involve legal precedent. The habits of a law professor die hard, however, and my experience has caused me to think more about the nature of industry self-regulation and, in particular, the fundamental principles underlying sanctions imposed by an industry regulator. This Article, the product of that exercise, describes, in Part I, the evolution of securities self-regulation since the 1938 Maloney Act and, in Part II, the theory and practice of FINRA sanctions.

I. THE EVOLUTION OF SECURITIES SELF-REGULATION

A. CONTRASTING VIEWS ON SECURITIES SELF-REGULATION

Although regulation of the broker-dealer industry by an SRO has long been part of the federal regulatory system, the model of self-regulation has not migrated to other participants and products regulated under the federal securities laws. In recent years Congress has considered authorizing SROs for mutual funds[15] and investment advisers;[16] in both instances, however, the proposals did not move forward. While there can be many reasons why new SROs did not come into existence,[17] the lack of enthusiasm for them may suggest doubts about the self-regulatory model. Both Congress and the SEC have viewed it with suspicion and refer to "the natural lack of enthusiasm for regulation on the part of the group to be regulated"[18] as a serious flaw in the self-regulatory model. According to the SEC, "[i]nherent in self-regulation is the conflict of interest that exists when an organization

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14. Of the 2013 NAC members, all of the seven public members are lawyers (five of them law professors), and three of the industry members (Mahon, Ostergaard, and Senatore) are lawyers. *See National Adjudicatory Council*, FINRA, http://www.finra.org/Industry/Enforcement/Adjudication/NAC/naccommittee/ (last updated Jan. 17, 2013).

15. *See* Barbara Black, *Are Retail Investors Better Off Today?*, 2 BROOK. J. CORP. FIN. & COM. L. 303, 319–20 & nn.113–14 (2008) (describing congressional consideration of new models for regulating mutual fund industry as aftermath of the market timing and late trading abuses).

16. Section 914(a)(2)(B) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1830 (2010) (codified as amended at 15 U.S.C. § 80b-11), required the SEC to report to Congress on the extent to which an SRO for investment advisers would improve the frequency of examinations of investment advisers. The SEC's study, conducted by the Staff of the Division of Investment Management of the SEC, set forth three options to address the SEC's lack of resources to conduct regular examinations, including authorization of one or more SROs to examine registered investment advisers. *See* STAFF OF THE DIV. OF INV. MGMT. OF THE SEC, STUDY ON ENHANCING INVESTMENT ADVISER EXAMINATIONS 39 (2011), *available at* http://www.sec.gov/news/studies/2011/914studyfinal.pdf.

17. *See* Mark Schoeff Jr., *At Crucial Hearing, Deck Will Be Stacked Against SRO Opponents*, INVESTMENT NEWS, http://www.investmentnews.com/article/20120605/BLOG07/120609962 (last visited Nov. 17, 2013). Both the mutual fund and investment advisory industries opposed regulation by an SRO, at least in part because of additional costs associated with another regulator. *Id.* In addition, FINRA initially sought to become the SRO for investment advisers, which the advisory industry fought because it views the regulatory model for investment advisers as fundamentally different from the broker-dealer model. *Id.*

18. SECURITIES INDUSTRY STUDY, S. REP. NO. 93-13, at 145 (1973) [hereinafter SECURITIES INDUSTRY STUDY].

both serves the commercial interests of and regulates its members or users."[19] In addition to a tendency to protect the economic interests of its members, there are persistent concerns about uneven and discriminatory enforcement, particularly by larger, more established firms against smaller, newer entrants.[20]

There is, however, an alternative, positive view of the self-regulatory model that has plausibility. Indeed, no one may be more motivated to discipline brokers and to remove bad brokers from the industry than the industry itself.[21] Good firms spend considerable resources on training their salespersons and other employees and on maintaining compliance programs to prevent violations; bad firms, in contrast, scrimp on these costs. The actions of bad actors, nevertheless, will cost the entire industry in terms of loss of investor confidence and increased government surveillance.[22] In addition, self-regulation may be more effective than government regulation because of industry experience and expertise, the ability to perform detailed oversight functions, and greater acceptance of regulation by the industry rather than by the government.[23] It is frequently asserted that industry regulators can enforce ethical standards that are loftier than mere legal compliance,[24] although, as I discuss later on, this assertion, if ever true, is questionable today.[25] Finally, as a practical matter, the size of the brokerage industry means that the SEC could not be the primary enforcer without a significant infusion of resources, and the federal government prefers that

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19. Concept Release Concerning Self-Regulation, Exchange Act Release No. 50,700, 2004 WL 2648179 § I, at *2 (Nov. 18, 2004) [hereinafter SEC Concept Release].

20. *See infra* notes 94–103 and accompanying text (discussing the NASD's 1996 scandal involving collusion among market makers); *see also* SEC Concept Release, *supra* note 19, § IV.A.I, at *7 (discussing concerns about undue influence of large member firms).

21. *See* Paul S. Grant, *The National Association of Securities Dealers: Its Origin and Operation*, 1942 WIS. L. REV. 597, 608 (describing disciplinary proceedings and stating that "the experience and judgment of men in the business are the best qualifications for fair, even strict determination of findings and penalties" and "[t]he members passing on complaints are determined that the industry will raise its standards"); *see also* Onnig H. Dombalagian, *Self and Self-Regulation: Resolving The SRO Identity Crisis*, 1 BROOK. J. CORP. FIN. & COM. L. 317, 321–22 (2007) (describing reciprocal regulation to signal higher standards of care adhered to by SRO members).

22. William A. Birdthistle & M. Todd Henderson, *Becoming a Fifth Branch*, 99 CORNELL L. REV. 1, 8–12 (2013).

23. SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES EXCHANGE COMMISSION, H.R. REP. NO. 88-95, pt. 4, at 693–94 (1963) [hereinafter SEC SPECIAL STUDY]; JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 439 (3d ed. 2003).

24. SEC SPECIAL STUDY, *supra* note 23, at 722.

25. For example, it is unlikely that the NASD could enforce a view of manipulation that was contrary to the SEC's. *See infra* notes 104–107 and accompanying text (discussing NASD v. SEC, 431 F.3d 803 (D.C. Cir. 2005)). In Dep't of Mkt. Regulation v. Leighton, Complaint No. CLG050021, 2010 WL 781457, at *2 (FINRA NAC Mar. 3, 2010), the NAC reversed the findings of the Extended Hearing Panel's majority based on a "tenuous" industry standard that limited the profits an institutional sales trader could make on trades.

the industry pay these regulatory costs.[26] For this reason alone, whatever the assessment of its strengths and weaknesses, self-regulation of the broker-dealer industry is here to stay.

B. THE CURRENT STATUTORY FRAMEWORK

Section 15A of the Exchange Act, which provides for the registration with the SEC of national securities associations, has been amended frequently since its initial enactment in 1938 in the Maloney Act.[27] We first set forth the current statutory framework and then discuss the legislative history of the Maloney Act and subsequent significant developments.

Section 15A provides that an association of brokers and dealers may be registered as a "national securities association" (NSA) if it applies for registration with the SEC and meets the statutory requirements as well as others prescribed by the SEC.[28] In order for an association of brokers and dealers to be registered as an NSA, the SEC must make a number of determinations, including that the association is "able to carry out the purposes of [the Exchange Act]" and "to enforce compliance by its members and persons associated with its members, with the provisions" of the Exchange Act and its rules and the rules of the association.[29] The association must adopt rules designed for a variety of enumerated purposes, including "to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade . . . , and, in general, to protect investors and the public interest."[30] The association's rules must provide for appropriate discipline of its members and associated persons for violations of the Exchange Act and its rules and the association's rules.[31] The statute authorizes a broad range of sanctions, including "expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction."[32]

The statute requires that the association's rules set forth "a fair procedure" for the discipline of its members and associated persons.[33] In

26. *See* SEC Concept Release, *supra* note 19, § IV.D, at *19 (citing self-funding as "[o]ne of the key historical benefits" of securities self-regulation); DIV. OF MKT. REGULATION, SEC, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS app. at VI - 6 (1994), *available at* http://www.sec.gov/divisions/marketreg/market2000.pdf (explaining that experience with the Securities and Exchange Commission Only (SECO) program shows that SEC resources necessary to assume direct regulation of broker-dealers "are not realistically attainable").

27. Exchange Act, Pub. L. No. 75-719, sec. 1, § 15A, 52 Stat. 1070, 1070–75 (codified as amended at 15 U.S.C. § 78o-3 (2012)).

28. 15 U.S.C. § 78o-3(a).

29. *Id.* § 78o-3(b)(2).

30. *Id.* § 78o-3(b)(6).

31. *Id.* § 78o-3(b)(7).

32. *Id.*

33. *Id.* § 78o-3(b)(8).

addition, the statute specifies certain procedures to assure notice and an opportunity to be heard, as well as the creation of a reviewable record. In any disciplinary proceeding, the association must "bring specific charges, notify such member or person of, and give him an opportunity to defend against, such charges, and keep a record."[34] A determination to impose a disciplinary sanction must be accompanied by a statement setting forth (A) the act or practice that the member or associated person was found to have engaged or found to have omitted; (B) the specific provision of the Exchange Act, its rules, or the SRO rules which the act, practice, or omission violated; and (C) the sanction imposed and the reason for it.[35]

FINRA disciplinary proceedings are heard before a panel chaired by a professional hearing officer and two industry representatives.[36] Any party may seek to appeal a hearing panel's decision to the NAC, and the NAC may decide on its own to hear an appeal.[37] The NAC's decision is FINRA's final action on the matter unless FINRA's Board of Governors decides to review it.[38]

All disciplinary proceedings are subject to de novo review by the SEC, on the agency's own motion or upon application by any "aggrieved" person.[39] So that the SEC is kept apprised of SRO disciplinary proceedings, the SRO is required to provide the agency notice of any final disciplinary sanction containing such information as the agency requires by rule.[40] To uphold any sanction imposed by the SRO, the SEC must make findings that the member or associated person

> has engaged in such acts or practices, or has omitted such acts, as the self-regulatory organization has found him to have engaged in or omitted, that such acts or practices, or omissions to act, are in violation of such provisions of this chapter, the rules or regulations thereunder, [or] the rules of the self-regulatory organization, . . . and that such provisions are, and were applied in a manner, consistent with the purposes of this chapter.[41]

If, however, the SEC does not make the requisite findings of a violation, then it must set aside the sanction and, "if appropriate," remand to

34. *Id.* § 78o-3(h)(1).
35. *Id.*
36. *Adjudication*, FINRA, http://www.finra.org/Industry/Enforcement/Adjudication/ (last visited Nov. 17, 2013). FINRA Code of Procedure Rules 9231 and 9232 set forth the criteria for selection of panelists. *Code of Procedure*, FINRA, http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=3895&record_id=11675 (last visited Nov. 17, 2013).
37. *Adjudication*, *supra* note 36.
38. *Id.*
39. 15 U.S.C. § 78s(d)(2).
40. *Id.* § 78s(d)(1). The notice requirement is set forth in SEC Rule 19d-1. Notices by Self-Regulatory Organizations, 17 C.F.R. § 240.19d-1 (2013).
41. 15 U.S.C. § 78s(e)(1)(A).

the SRO for further proceedings.[42] Moreover, after the SEC makes the requisite findings of a violation, if it finds, "having due regard for the public interest and the protection of investors," that the sanction imposed by the SRO "imposes any burden on competition not necessary or appropriate in furtherance of the purposes of this chapter or is excessive or oppressive," then it may "cancel, reduce, or require the remission of such sanction."[43] Although the statute is phrased in terms of agency discretion, according to the D.C. Circuit, the SEC *must*, when reviewing a FINRA disciplinary action, consider whether the sanction is "excessive or oppressive" and must carefully consider any aggravating or mitigating factors relevant to the determination of an appropriate sanction.[44]

Finally, the Exchange Act provides for judicial review of an SEC final order by a "person aggrieved" by the order.[45] The standard of review is the "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law" standard set forth in the Administrative Procedure Act.[46]

C. EVOLVING VIEWS ON SECURITIES SELF-REGULATION

Since its inception in 1939, FINRA (including its predecessor, the NASD) has evolved from a membership association primarily responsible for enforcing industry norms to a regulator that enforces federal securities laws as an adjunct of the SEC. This section summarizes the milestones in that development.[47]

1. The Maloney Act

The original concept of securities self-regulation was that of membership associations having contractual powers to enforce sound business practices and ethical standards that were considered beyond the scope of government regulation.[48] As described by William Douglas:[49]

> Self-regulation . . . can be pervasive and subtle in its conditioning influence over business practices and business morality. By and large, government can operate satisfactorily only by proscription. That leaves untouched large areas of conduct and activity; some of it susceptible of

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42. *Id.* § 78s(e)(1)(B).

43. *Id.* § 78s(e)(2). The SEC also has discretion to remand to the SRO for further proceedings. *Id.* § 78s(e)(1)(A).

44. Saad v. SEC, 718 F.3d 904, 909, 913 (D.C. Cir. 2013).

45. 15 U.S.C. § 78y(a)(1).

46. Administrative Procedure Act, Pub. L. No. 89-554, § 706(2)(A), 80 Stat. 378, 393 (1966) (codified as amended at 5 U.S.C. § 706(2)(A) (2012)); *Saad*, 718 F.3d at 910.

47. *See generally* Karmel, *supra* note 10 (describing how at least some of the "self" has been taken out of FINRA).

48. SELIGMAN, *supra* note 23, at 186.

49. Justice Douglas served as Chairman of the SEC from 1937–39. *SEC Historical Summary of Chairmen and Commissioners*, SEC, http://www.sec.gov/about/sechistoricalsummary.htm (last visited Nov. 17, 2013).

government regulation but in fact too minute for satisfactory control; some of it lying beyond the periphery of the law in the realm of ethics and morality. Into these larger areas self-government and self-government alone, can effectively reach.[50]

The Exchange Act, as enacted in 1934, designated national securities exchanges, principally the New York Stock Exchange (NYSE), as SROs with the responsibility to regulate member broker-dealers but did not provide for self-regulation of broker-dealers operating in the over-the-counter (OTC) markets. Congress addressed this lacuna in 1938. The Maloney Act amended the Exchange Act to set up "a system for cooperative regulation of the over-the-counter markets, through the activities of voluntary associations of investment bankers, dealers and brokers doing business in these markets, under appropriate governmental supervision."[51] The legislative history identified three aspects to regulation of the OTC markets:

> First, to protect the investor and the honest dealer alike from dishonest and unfair practices by the submarginal element in the industry; second, to cope with those methods of doing business which, while technically outside the area of definite illegality, are nevertheless unfair both to customer and decent competitor, and are seriously damaging to the mechanism of the free and open market; and, third, to afford to the investor an economic service the efficiency of which will be commensurate with its economic importance, so that the machinery of the Nation's markets will operate to avoid the misdirection of the Nation's savings, which contributes powerfully toward economic depressions and breeds distrust of our financial processes.[52]

Congress identified two regulatory alternatives. Rejecting the first, a "pronounced expansion of the [SEC]," with a large increase in expenditure of public funds, accompanied by "a minute, detailed, and rigid regulation of business conduct by law,"[53] Congress opted for "cooperative regulation,"[54] as described by Senator Maloney:

> The Federal Government, through the Securities and Exchange Commission, says to the investment bankers of the country, "You may create your own association or associations. You may provide your own rules and your own regulations. We want you to run your own business. We want a representation, however. We want a right of review and supervision." So, while some of us would like to call what is provided for

50. SECURITIES INDUSTRY STUDY, *supra* note 18, at 149.

51. REGULATION OF OVER-THE-COUNTER MARKETS, H.R. REP. NO. 75-2307, at 2 (1938); REGULATION OF OVER-THE-COUNTER MARKETS, S. REP. NO. 75-1455, at 1 (1938).

52. H.R. REP NO. 75-2307, at 4.

53. *Id.*

54. *Id.*

> self-regulations, it is in effect a cooperative regulation . . . . It is purely voluntary.[55]

Similarly, the purpose of the legislation was "to enable the people of this business to guide and direct the affairs of their own industry under government supervision."[56] The legislation presupposed that "regulation can best be achieved by the efforts of honest brokers and dealers themselves . . . ."[57] The SEC is "injected into the association or associations to prevent the growth of monopoly and to protect the rights of minorities, and the little dealer as well as the small buyers."[58]

Consistent with the concept that the membership associations would enforce their own rules, Exchange Act section 15A, as originally enacted, did not explicitly give NSAs the authority to bring disciplinary proceedings for violations of federal securities laws and regulations.[59] It was not until the 1975 amendments to the Exchange Act that NSAs had express authority to enforce the Exchange Act and its rules, although prior thereto, the NASD had enforced at least some federal securities provisions through its general requirement of "high standards of commercial honor and just and equitable principles."[60]

The NASD was established in 1939 and was—and continues to be through its successor, FINRA—the sole NSA for broker-dealers.[61]

2. The SEC's Special Study of Securities Markets

In 1961 Congress appropriated funds for the SEC to undertake "a broad study of the adequacy of investor protection in the securities markets,"[62] including an examination of the OTC market. Joel Seligman, the foremost historian of the SEC, described the *Special Study of Securities Markets* (the *Special Study*), conducted by a quasi-independent group within the SEC, as "the single most influential document published in the history of the SEC."[63] A principal component of the *Special Study* is "a factual documentation of the limits of self-regulation in the securities industry,"[64] including the performance of the securities exchanges and the NASD as well as the SEC's oversight of them.

The *Special Study* described the evolution of the NASD from "a somewhat unique experiment in supervised self-regulation" to "an

55. 83 CONG. REC. 4451 (1938) (statement of Sen. Francis Maloney).

56. Senator Francis Maloney, Radio Address on Over-the-Counter Securities Markets (Feb. 25, 1938), *in* 83 CONG. REC. app. at 789 (1938).

57. *Id.* at 790.

58. *Id.*

59. *See* SEC SPECIAL STUDY, *supra* note 23, at 646.

60. *Id.* at 646 n.420.

61. *See supra* note 2 and accompanying text.

62. SEC SPECIAL STUDY, *supra* note 23, pt. 1, at iii (Letter of Transmittal).

63. SELIGMAN, *supra* note 23, at 299.

64. *Id.*

established part of the regulatory scheme exerting a substantial influence on numerous phases of the securities industry."[65] In its judgment, the NASD was at a crossroads[66] because "its capacity to do its job is overtaxed:"[67] "The NASD's job of self-regulation is an enormous one in every dimension, but from the beginning it has sought to adhere to a concept of self-regulation with a maximum emphasis on 'self'—members in the securities business regulating themselves—and with minimal reliance on full-time paid staff."[68]

With respect to the NASD's disciplinary proceedings, the *Special Study* reported that the NASD "placed great emphasis on informality and simplicity in all phases of the disciplinary process"[69]—what was important to the membership was that decisions were "made by businessmen based upon their knowledge of the procedures of their business."[70] The *Special Study* concluded that the principal problem with disciplinary proceedings was lack of efficiency and speed in handling cases;[71] it also found troubling disparities in the penalties for certain kinds of misconduct that suggested discrimination against smaller firms.[72]

To address the NASD's deficiencies, the *Special Study* called for the creation of a larger professional staff with greater responsibilities,[73] centralization of enforcement authority, and permanent hearing officers for disciplinary hearings.[74] In addition, the *Special Study* observed that the NASD's "purpose of promoting voluntary compliance with ethical standards beyond the reach of formal regulation has limited its resort to codification or other 'legalistic' techniques that might ease its burden of day-to-day regulation."[75] In short, in the view of the *Special Study*, the NASD should become more bureaucratic, with a professional staff and a rulebook. These recommendations signaled a significant change in the

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65. SEC SPECIAL STUDY, *supra* note 23, at 673.

66. *Id.* at 674.

67. *Id.*

68. *Id.*; *see* Howard C. Westwood & Edward G. Howard, *Self-Government in the Securities Business*, 17 L. & CONTEMP. PROBS. 518, 533 (1952) (describing how, when the NASD applied to register with the SEC, it originally contemplated that it would not need a paid staff, but the SEC objected and also thought the proposed schedule of membership fees was too low).

69. SEC SPECIAL STUDY, *supra* note 23, at 664.

70. *Id.* at 665 (quoting letter from the NASD's executive director); Grant, *supra* note 21, at 608 (describing disciplinary proceedings and stating that "the experience and judgment of men in the business are the best qualifications for fair, even strict determination of findings and penalties" and "[t]he members passing on complaints are determined that the industry will raise its standards").

71. SEC SPECIAL STUDY, *supra* note 23, at 681.

72. *Id.* at 666 (describing the relative leniency in free-riding cases in contrast to net capital violations; the former is not found primarily in marginal firms).

73. *Id.* at 676. "[T]he NASD's paid staff should be increased in size, stature, and responsibility . . . ." *Id.* at 680.

74. *Id.*

75. *Id.* at 679.

concept of securities self-regulation that was implemented in subsequent amendments to the Exchange Act.

3. 1964 Amendments to the Exchange Act

In 1964 Congress amended section 15A of the Exchange Act to require, for the first time, that NSAs have standards of financial responsibility for member firms and standards of training, experience, and other qualifications for associated persons. The amendment also permitted the NASD to bring disciplinary proceedings against associated persons without proceeding against their firms.[76] According to the Senate report accompanying the legislation, the amendments "contemplate[d] an even greater degree of reliance upon self-regulation, although under somewhat more intensive [SEC] supervision."[77]

In addition, the Senate report essentially repudiated the Maloney Act's concept of a voluntary membership association enforcing through contract its business and ethical standards on its members and instead emphasized that the association was a regulator acting pursuant to delegated authority: "Registered securities associations are not private clubs. They are organized under statutory authority to perform, under governmental oversight, regulatory functions in the over-the-counter securities market."[78]

This emphasis on delegated government power becomes the dominant theme in subsequent congressional consideration of the concept of securities self-regulation, although lip service is still paid to the Maloney Act's concept of self-regulation.

4. The Securities Industry Study of 1973

In 1970, when Congress enacted the Securities Investor Protection Act to address the crisis caused by the failures of a number of large NYSE firms and to deal with the threat of loss of investor confidence, a number of Senators expressed concern that the securities industry was in need of fundamental reform.[79] As a result, in 1971 the Senate authorized a thorough study of the securities industry and the securities markets, conducted by the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs, which was completed in 1973.[80] The *Securities Industry Study* made a number of conclusions and recommendations, many of them concerning industry self-regulation, including that "[t]he division of

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76. Summary and Interpretation of Amendments to Securities Act of 1933 and Securities Exchange Act of 1934 Contained in the Securities Acts Amendments of 1964, Securities Act Release No. 4725, Exchange Act Release No. 7425, 1964 WL 67875, at *15 (Sept. 29, 1964).

77. SECURITIES AND EXCHANGE COMMISSION LEGISLATION 1963, S. REP. NO. 88-379, at 42 (1963).

78. *Id.*

79. SECURITIES INDUSTRY STUDY, *supra* note 18, at 1.

80. *Id.* at 3.

responsibility between the SEC and the self-regulatory organizations requires redefinition to establish clearer lines of responsibility for decisionmaking."[81] The *Securities Industry Study* emphasized that

> there is a common and serious misunderstanding of the nature and limits of the concept of self-regulation . . . . [S]elf-regulation is thought to mean that the securities industry regulates itself and therefore is not regulated by the government. Such a conception of self-regulation is seriously misleading in failing to acknowledge the essential and continuing role of the federal government.[82]

The *Securities Industry Study* expressed a great deal of skepticism about securities self-regulation and described the

> inherent limitations in allowing an industry to regulate itself . . . : the natural lack of enthusiasm for regulation on the part of the group to be regulated, the temptation to use a façade of industry regulation as a shield to ward off more meaningful regulation, the tendency for businessmen to use collective action to advance their interests through the imposition of purely anti-competitive restraints as opposed to those justified by regulatory needs, and a resistance to changes in the regulatory pattern because of vested economic interests in its preservation.[83]

Despite this lack of enthusiasm for securities self-regulation, the *Securities Industry Study* acknowledged practical realities: that "the Congress was well aware of the serious practical problems confronting the government if it were to assume the *entire* regulatory burden."[84] Accordingly, Congress established a regulatory model that balanced the "limitations and dangers"[85] of self-regulation against "'the sheer ineffectiveness of attempting to assure [regulation] directly through the Government on a wide scale.'"[86]

In addition, the *Securities Industry Study* did acknowledge that securities self-regulation had significant advantages apart from its practical necessity, which included bringing industry members' expertise to bear on the regulatory issues and involving industry members in the regulatory process.[87] Indeed, what it identified as the most important advantage harkened back to the Maloney Act's original concept: "its potential for

81. *Id.* Seligman notes that Congress was frustrated with the SEC's passivity in supervising the SROs and that "[b]etween 1971 and 1975, the SEC's supervision of stock market regulation was the subject of almost incessant congressional hearings and reports." SELIGMAN, *supra* note 23, at 443.

82. SECURITIES INDUSTRY STUDY, *supra* note 18, at 137.

83. *Id.* at 145 (footnote omitted).

84. *Id.* at 146.

85. *Id.*

86. *Id.* (quotation marks in original).

87. *Id.* at 149.

establishing and enforcing what Mr. Justice Douglas referred to as 'ethical standards beyond those any law can establish.'"[88]

5. 1975 Amendments to the Exchange Act

Somewhat surprisingly, the NASD did not have express statutory authority to enforce the Exchange Act and its rules until the 1975 amendments to the Exchange Act.[89] The 1975 amendments also strengthened SEC oversight in several key respects, including procedures applicable to SEC review of SRO proposed rule changes[90] and SRO disciplinary actions.[91] In addition, Congress reinforced the notion that SROs are not "private clubs" by requiring that their governing bodies have at least one public member, i.e., not from the industry.[92]

Once again, the legislative history emphasized that "self-regulatory organizations exercise authority subject to SEC oversight. They have no authority to regulate independently of the SEC's control."[93]

6. The NASD's 1996 Scandal Involving Collusion Among Market Makers

In the 1990s, both the U.S. Department of Justice's Antitrust Division and the SEC investigated allegations of abusive practices by Nasdaq market makers to suppress competition and mislead customers.[94] In 1996 the SEC and the NASD entered a settlement after the agency instituted public proceedings against the NASD.[95] The SEC, in addition to making findings of misconduct in the Nasdaq market by Nasdaq market makers, found that the NASD inadequately enforced its rules applicable to market makers and processed certain membership applications in a manner inconsistent with its rules, both of which were attributable to the undue influence of market makers in the NASD regulatory processes.[96] The SEC also found that the

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88. *Id.* (footnote omitted).

89. Exchange Act, Pub. L. No. 94-29, sec. 12, § 15A, 89 Stat. 97, 127–31 (1975).

90. *Id.* sec. 16, § 19(b)–(c), 89 Stat. at 147–50.

91. *Id.* sec. 16, § 19(d)–(e), 89 Stat. at 150–51.

92. *Id.* sec. 12(2), § 15A(b)(4), 89 Stat. at 127.

93. SECURITIES ACTS AMENDMENTS OF 1975, S. REP. NO. 94-75, at 23 (1975), *reprinted in* 1975 U.S.C.C.A.N. 179, 201.

94. SEC, REPORT PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934 REGARDING THE NASD AND THE NASDAQ MARKET (1996) [hereinafter SEC, REPORT PURSUANT TO SECTION 21(A)], *available at* http://www.sec.gov/litigation/investreport/nasdaq21a.htm.

95. The SEC can impose sanctions on an SRO if it finds, on the record and after notice and opportunity for a hearing, that the SRO has violated or is unable to comply with any provision of the Securities Exchange Act and its rules, or the SRO's own rules. 15 U.S.C. § 78s(h)(1) (2012).

96. NASD, Exchange Act Release No. 37,538, 1996 WL 447193 (Aug. 8, 1996) [hereinafter NASD Release]. For background on the Nasdaq trading practices at issue, see SELIGMAN, *supra* note 23, at 698–702. Arthur Levitt, the SEC Chairman at the time, acknowledged that the SEC itself "failed to see that the NASD had gradually been taken over by a cabal of dealers who used the NASD's disciplinary process to punish certain players, such as daytraders, while failing to prosecute serious infractions by market-makers." *Id.* at 699 (quoting ARTHUR LEVITT, TAKE ON

influence exerted by the market makers resulted in the NASD staff's targeting less-favored constituencies in examinations and disciplinary actions.[97] The NASD did not admit or deny the findings.

In response to the scandal, prior to the SEC settlement, the NASD had already accepted the recommendation of its Select Committee headed by former Senator Warren Rudman to review Nasdaq structure and governance[98] and determined to separate the NASD's market and regulatory functions.[99] The SEC censured the NASD and required it to consent to a number of reforms, including reforms designed to reduce the influence of members over regulatory and disciplinary matters. Thus, the settlement required "at least 50% independent public and non-industry membership on its Board of Governors" and on the boards of all subsidiaries and affiliates that have self-regulatory functions, and on the major NASD committees, including the predecessor to the NAC, the National Business Conduct Committee.[100] The participation of industry members in disciplinary proceedings was also reduced. The NASD was required to institute the use of professional hearing officers—"who shall be attorneys with appropriate experience and training"—to preside over disciplinary proceedings.[101] In addition, the NASD was required "to provide for the autonomy and independence of the regulatory staff" so that the staff would have sole discretion as to what matters to investigate and prosecute, subject only to supervision of the Board of Governors, and would be "generally insulated from the commercial interests of its members and the Nasdaq market."[102]

As a result of this demonstration of the fatal flaw of securities self-regulation—the undue influence exerted by powerful members—the NASD's transformation into a professional regulator largely independent of its membership, as recommended by the 1963 *Special Study*, was substantially accomplished. Today, after the 2007 consolidation, FINRA describes itself as the "leading *non-governmental* regulator for all securities firms doing business with the U.S. public."[103]

THE STREET: WHAT WALL STREET AND CORPORATE AMERICA DON'T WANT YOU TO KNOW 183–84 (2002)).

97. Specifically, NASD staff targeted day trading firms that used Nasdaq's Small Order Execution System. *See* SEC, REPORT PURSUANT TO SECTION 21(A), *supra* note 94, at 40–44.

98. U.S. GEN. ACCOUNTING OFFICE, PUB. NO. GAO-02-362, SECURITIES MARKETS: COMPETITION AND MULTIPLE REGULATORS HEIGHTEN CONCERNS ABOUT SELF-REGULATION 11 (2002), *available at* http://www.gao.gov/assets/240/234468.pdf.

99. *Id.* at 8; *see also* SELIGMAN, *supra* note 23, at 701–02.

100. NASD Release, *supra* note 96, § IV.B.1, at *3.

101. *Id.* § IV.B.3.

102. *Id.* § IV.B.4, at *4.

103. *About FINRA: Leadership*, *supra* note 2 (emphasis added).

7. The Current View of Securities Self-Regulation

As this brief history demonstrates, the concept of FINRA has evolved from a voluntary membership organization enforcing through contract its business practices and ethical standards to a regulator that is independent from its membership, whose authority to enforce federal securities laws derives from Congress and is subject to SEC oversight. Two appellate opinions underscore this transformation.

In *NASD v. SEC*, the NASD sought judicial review of an SEC order that set aside the NAC's findings of market manipulation in violation of Exchange Act section 10(b) and Rule 10b-5 and the sanctions imposed for that violation, which were expulsion of the member firm and an industry bar of its owner.[104] The SEC concluded that the evidence did not establish that the respondents committed market manipulation.[105] In ruling that the NASD did not have standing to appeal the SEC order, the D.C. Circuit described it as a "quasi-governmental agency, with express statutory authority to adjudicate actions against members who are accused of illegal securities practices and to sanction members found to have violated the Exchange Act or [SEC] regulations issued pursuant thereto."[106] The NASD's subordinate status was clear. Under the statutory scheme providing for securities self-regulation, "[t]he NASD's authority to discipline its members for violations of federal securities law is entirely derivative. The authority it exercises ultimately belongs to the SEC, and the legal views of the self-regulatory organization must yield to the Commission's view of the law."[107]

The court held that the NASD, as a first-level adjudicator, was not a "person aggrieved" that can appeal an SEC decision under Exchange Act section 25(a).[108] It rejected summarily the NASD's argument that it was "an aggrieved person" based on its staff's frustration in its mission because it would be unable to bring disciplinary proceedings except in the narrow circumstances covered by the SEC decision:[109] "Simply put, the NASD

104. NASD v. SEC, 431 F.3d 803, 804–05 (D.C. Cir. 2005). As the court noted throughout the opinion, this was the first case in nearly seventy years in which the NASD sought judicial review of an SEC order when the NASD was acting as an adjudicator. *Id.* at 811.

105. The NAC stated that the question presented by the appeal was "whether a market marker that trades a small volume of stock can violate the antifraud provisions of SEC and NASD rules when the evidence demonstrates that the firm took actions that were designed to artificially increase the price of the stock" and answered the question in the affirmative. Mkt. Regulation v. Elgindy, Complaint No. CMS000015, 2003 WL 21203080, at *1 (NASD NAC May 7, 2003). The SEC, however, concluded that the record did not support a finding that the respondents' actions were part of a manipulative scheme. Elgindy, Exchange Act Release No. 49,389, 2004 WL 865791, at *4–5 (Mar. 10, 2004).

106. *NASD*, 431 F.3d at 804.

107. *Id.* at 806.

108. *Id.* at 805.

109. *Id.* at 809–10.

appears before this court as a disgruntled first-level tribunal, complaining because it has been reversed by a higher tribunal."[110]

The question left unaddressed by *NASD v. SEC* was whether FINRA could adopt and enforce its own definition of market manipulation apart from the Exchange Act as a violation of its requirement that members observe "high standards of commercial honor and just and equitable principles of trade."[111] *Fiero v. FINRA*,[112] discussed next, suggests that courts would not be receptive to efforts to impose significant sanctions for violations that were based solely on ethical standards that go beyond the antifraud provisions of the Exchange Act.

Fiero even more clearly demonstrates that courts view FINRA's powers as exclusively derived from the Exchange Act.[113] In 2002 the NAC affirmed a hearing panel's findings that Fiero Brothers, Inc., a member firm, and John Fiero, its president (collectively, the Fieros) engaged in market manipulation and its sanctions of expulsion/bar from the industry and a $1 million fine imposed jointly and severally on the Fieros.[114] The Fieros did not appeal the NAC's decision to the SEC.[115] After the Fieros refused to pay the fine, FINRA commenced an action in New York state court.[116] The trial court awarded judgment in its favor, upholding its authority to bring the action under contract law, because the Fieros had agreed to comply with the SRO's rules, including imposition of fines and sanctions, when the firm became a NASD member and Fiero became an associated person of the firm.[117] The court further noted that "'New York state courts have long recognized the right of a private membership organization to impose fines on its members, when authorized to do so by statute, charter or by-laws.'"[118] New York's highest court, however, subsequently reversed on the ground that the federal courts possessed exclusive jurisdiction because the FINRA complaint was an action to

110. *Id.* at 809.

111. *FINRA Rules*, FINRA, http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=607&record_id=609 (last visited Nov. 17, 2013) (FINRA Rule 2010, formerly NASD Conduct Rule 2110).

112. Fiero v. FINRA, 660 F.3d 569 (2d Cir. 2011).

113. *See id.* at 576.

114. The hearing panel also found, and the NAC affirmed, a finding that the Fieros violated a NASD Rule. The NAC imposed the $1 million fine for the market manipulation claim. Dep't of Enforcement v. Fiero, Complaint No. CAF980002, 2002 WL 31476976, at *33 n.60 (NASD NAC Oct. 28, 2002).

115. If the Fieros had appealed and the SEC had affirmed the NAC fine, the SEC would have had the authority to bring a proceeding to collect the fine under Exchange Act § 21(e). *Fiero*, 660 F.3d at 574–75; *but see id.* at 575 n.7 (expressly noting that the issue of SEC authority was not before the court).

116. NASD v. Fiero, No. 102755/04, 2006 WL 5251396 (N.Y. Sup. Ct. May 11, 2006).

117. NASD v. Fiero, 882 N.E.2d 879 (N.Y. 2008).

118. *Fiero*, 660 F.3d at 572 (citing NASD v. Fiero, No. 102755/04, slip op. at 2 (N.Y. Sup. Ct. Sept. 12, 2005), *rev'd on other grounds*, 882 N.E.2d 879 (N.Y. 2008)).

enforce a liability or duty created under the Exchange Act.[119] The Fieros then brought an action in federal district court, seeking a declaratory judgment that FINRA had no authority to collect fines through judicial proceedings; FINRA filed a counterclaim, again seeking to enforce the fine under contract theory.[120] Reversing the district court's judgment in favor of FINRA, the court of appeals held that the Exchange Act did not confer on FINRA authority to bring judicial actions to enforce collection of its fines.[121]

The court of appeals' analysis was based on the premise that "where FINRA enforces statutory or administrative rules, *or enforces its own rules promulgated pursuant to statutory or administrative authority*, it is exercising the powers granted to it under the Exchange Act."[122] The court of appeals relied principally on the statutory language: while Exchange Act section 15A(b) confers on SROs the power and obligation to discipline members and impose sanctions, including fines, the Exchange Act did not expressly confer on SROs the power to bring judicial actions to collect fines.[123] The court contrasted this with statutory provisions conferring express power on the SEC to seek judicial enforcement of monetary penalties and concluded on this basis that the omission of comparable power to SROs was intentional.[124] The court also found that FINRA's breach of contract theory undermined Exchange Act section 27, which confers on federal courts exclusive jurisdiction to enforce the Exchange Act, explaining that "FINRA contract enforcement actions may bristle with Exchange Act legal issues because the most serious fines levied by FINRA will be for member violations of the Act."[125] Assuming that the court was correct in its assertion that FINRA's largest fines are imposed for Exchange Act violations, it did not explain how an action brought to collect a fine would require courts to interpret the Exchange Act.[126]

The court acknowledged that its interpretation left a "seemingly inexplicable nature of a gap in the FINRA enforcement scheme: fines may be levied but not collected."[127] The court, however, did not find this troublesome because FINRA had another "draconian sanction not involving court action:"[128] it could expel the member from the industry for non-

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119. *Fiero*, 882 N.E.2d at 882.

120. Fiero v. FINRA, 606 F. Supp. 2d 500, 502 (S.D.N.Y. 2009).

121. *Fiero*, 882 N.E.2d at 882.

122. *Fiero*, 660 F.3d at 575–76 (emphasis added).

123. *Id.* at 574.

124. *Id.* at 575.

125. *Id.* at 576.

126. *Cf.* Fiero v. FINRA, 606 F. Supp. 2d 500, 517–18 (S.D.N.Y. 2009) (rejecting this argument because FINRA is not suing for violations of securities laws or introducing disciplinary proceedings as evidence of the Fieros' securities violations).

127. *Fiero*, 660 F.3d at 576.

128. *Id.*

payment or, in this case, refuse to permit the Fieros to re-enter the industry until they paid the fine.[129] In addition, in a non sequitur, the court observed that a violator of the Exchange Act would likely face a "panoply of private and SEC remedies."[130]

Both opinions view the Exchange Act as the exclusive source of authority for FINRA; the organization has no independent power or authority. In addition, both opinions adhere to a literal, non-expansive interpretation of the association's statutory authority. Neither opinion offers FINRA any encouragement to explore new regulatory approaches or to be innovative in its approach to regulation; both opinions emphasize that FINRA was asserting a power that it had not previously attempted to exercise.

The current view of securities self-regulation may be a significant cabining of FINRA's ability to enforce ethical standards beyond the antifraud provisions of the Exchange Act for the protection of retail investors. Yet, because of the seriousness of the sanctions, broker-dealers and associated persons need fair notice of what kinds of conduct constitute violations; the law cannot be "soft" or vague. Moreover, the 1996 market-maker scandal demonstrated that the historic concern for undue industry influence was not misplaced and that Congress was correct in identifying the need for more independence from the industry and greater SEC oversight.

II. FINRA SANCTIONS

As previously described, the Exchange Act requires FINRA to adopt rules to regulate the conduct of its members[131] and to provide for appropriate discipline of firms and associated persons for violations of the Exchange Act and its rules, as well as the SRO's rules.[132] The statute authorizes a broad range of sanctions and confers broad discretion on FINRA to determine the appropriate sanction, subject to the SEC's power to reduce a sanction if it imposes an undue burden on competition or is "excessive or oppressive."[133] Part II fleshes out the bare statutory framework and explores the theory and practice of FINRA sanctions.

A. REMEDIAL VERSUS PUNITIVE SANCTIONS

Recall that this Article started with the premise that it is likely, and indeed understandable, that members of the investing public who have been harmed by broker-dealer misconduct want to see that bad brokers are

129. *Id.*
130. *Id.*
131. 15 U.S.C. § 78o-3(b)(6) (2012).
132. *Id.* § 78o-3(b)(7).
133. *See supra* notes 43–44 and accompanying text.

punished for their wrongdoing.[134] Public approval for regulators may decrease if they are seen as "soft" on violators; Robert Khuzami, the former SEC Director of the Enforcement Division, frequently reminded people that the SEC was not a federal prosecutor.[135] The investing public may be especially skeptical about industry regulators and suspect them of being soft on offenders. Moreover, regulators (like the rest of us) probably find it satisfying to punish; industry regulators may feel a strong sense of disapproval toward conduct that reflects badly on the industry as a whole.[136] Nevertheless, regulators may not impose sanctions as retribution, because the wrongdoers deserve it, however satisfying that may be to both the regulators and the investing public.[137]

Why is it impermissible for FINRA to punish bad brokers for their conduct? First, FINRA is a private actor, not an arm of the federal government. Courts, however, have long recognized that Congress can confer on private bodies the power to impose sanctions, including the revocation of licenses.[138] The right of disciplined firms and associated persons to seek de novo SEC review of FINRA's findings and sanctions, and the statutory requirement that the agency make its own findings, provide an additional layer of protection for the individual or firm found to have committed a violation.[139] In their review of disciplinary orders, the federal courts of appeals do not distinguish between SEC orders that affirm FINRA disciplinary sanctions and SEC orders that affirm sanctions imposed through the SEC's administrative hearing system; both are

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134. *See, e.g.*, *113 Madoff Victims Tell Their Stories*, WALL ST. J., June 16, 2009, at C3, *available at* http://online.wsj.com/article/SB124511290745717267.html (reproducing victim-impact statements from 113 victims of Bernard Madoff's Ponzi scheme filed with court in advance of Madoff's sentencing).

135. *See, e.g.*, Robert Khuzami, Dir., Div. of Enforcement, SEC, Remarks Before the Consumer Federation of America's Financial Services Conference (Dec. 1, 2011), *available at* http://www.sec.gov/news/speech/2011/spch120111rk.htm (explaining that some of the frustration at SEC's performance was rooted in misunderstandings of the SEC's powers as a civil enforcement agency).

136. Recent scholarship explaining why public actors choose retributive responses to wrongdoing include Miriam H. Baer, *Choosing Punishment*, 92 B.U. L. REV. 577, 577 (2012) and Max Minzner, *Why Agencies Punish*, 53 WM. & MARY L. REV. 853, 853–54 (2012).

137. Minzner, *supra* note 136, at 904–13 (explaining why there are significant reasons to be concerned about agencies as retributive entities).

138. *See* Bd. of Trade v. Wallace, 67 F.2d 402, 407 (7th Cir. 1933); *see also* Markowski v. SEC, 34 F.3d 99, 105 (2d Cir. 1994) (rejecting challenges to disciplinary sanctions, noting that the individual voluntarily submitted himself to the discipline of a self-regulating association whose power to enforce its standards of conduct "makes its imprimatur meaningful and commercially valuable to its membership"). In addition, the laws of many states recognize that private-membership associations may impose sanctions on members when authorized by statute or governance documents. *E.g.*, NASD v. Fiero, No. 102755/04, slip op. at 2 (N.Y. Sup. Ct. Sept. 12, 2005), *rev'd on other grounds*, 882 N.E.2d 879 (N.Y. 2008).

139. *See* Cody v. SEC, 693 F.3d 251, 257 (1st Cir. 2012) (stating that court reviews SEC order rather than FINRA's decision); Heath v. SEC, 586 F.3d 122, 142–43 (2d Cir. 2009) (stating that any procedural errors committed by the hearing officer are cured by the SEC's thorough de novo review of the record).

considered SEC orders. Accordingly, parties rarely raise the objection that FINRA is not a government body, and if the objection is raised, courts quickly dispense with it.

The Exchange Act requires that the SRO provide a "fair procedure" for its disciplinary proceedings,[140] which specifically includes providing specific charges and an opportunity to be heard.[141] Fairness requires that the firm or individual has notice that the charged conduct was illegal[142] and that the SRO bring the charges without undue delay.[143] The protections accorded those charged with misconduct, however, do not raise to the level of constitutional protections required when the government seeks to impose criminal sanctions on those charged with misconduct: need for proof beyond a reasonable doubt, trial by jury, privilege against self-incrimination (for individuals), protection from double jeopardy, and right to legal representation.[144] Courts have dispensed with these constitutional protections so long as the sanction is remedial and not penal, or punishment, for past offenses.[145] The Supreme Court defers to legislative intent, so that conferring a regulatory authority with the power to impose sanctions denominated as "civil" is prima facie evidence of congressional intent to provide for a non-criminal sanction.[146] The Court, however, recognizes that even if Congress intended civil sanctions, a statutory scheme can be so punitive either in purpose or effect as to "'transfor[m]

140. 15 U.S.C. § 78o-3(b)(8) (2012). Courts have held that the FINRA procedures mandated by the Exchange Act require the substance of procedural due process, *Cody*, 693 F.3d at 357, and are fair, *see* Busacca v. SEC, 449 Fed. App'x 886, 891 (11th Cir. 2011), and that procedural errors committed by the hearing officer can be cured by the SEC's thorough de novo review of the record. *Heath*, 586 F.3d at 142–43.

141. 15 U.S.C. § 78o-3(h)(1).

142. Even a minimal sanction can be excessive if the individual could not fairly understand that the conduct was illegal. Upton v. SEC, 75 F.3d 92, 98 (2d Cir. 1996).

143. SRO disciplinary proceedings are not subject to any statute of limitations; "a successful laches defense requires a lack of due diligence by the [SRO], and prejudice to the [respondent]." Gluckman, Exchange Act Release No. 41,628, 1999 WL 507864, at *6–7 (July 20, 1999). The SEC dismissed, for the first time, an SRO disciplinary proceeding on fairness grounds because of the age of the case, without a showing of prejudice, in Hayden, Exchange Act Release No. 42,772, 2000 WL 571683, at *2 (May 11, 2000), because an SRO has a "statutory obligation to ensure the fairness and integrity of its disciplinary proceedings." In Dep't of Enforcement v. Morgan Stanley DW Inc., Discip. Proceeding No. CAF000045, 2002 NASD Discip. LEXIS 11 (NASD NAC July 29, 2002), the NAC interpreted *Hayden* as setting forth a fairness test based on equitable principles and requiring consideration of the facts and circumstances of the particular case.

144. *See, e.g.*, Steadman v. SEC, 450 U.S. 91, 96–103 (1991) (holding that because the Congress set forth a preponderance of evidence standard for disciplinary proceedings under the Investment Company Act of 1940 and the Investment Advisers Act of 1940, policy arguments for a higher standard were inapposite).

145. Wright v. SEC, 112 F.2d 89, 94 (2d Cir. 1940).

146. Hudson v. United States, 522 U.S. 93, 99–103 (1997) (holding that the statutory scheme under which Office of Comptroller of Currency imposed penalties and debarment on bank officers demonstrated congressional intent that such penalties be deemed civil, so that the double jeopardy clause did not protect against criminal prosecution).

what was clearly intended as a civil remedy into a criminal penalty.'"[147] The Court has identified relevant factors in distinguishing between punitive and remedial sanctions:

> (1) [w]hether the sanction involves an affirmative disability or restraint; (2) whether it has historically been regarded as a punishment; (3) whether it comes into play only on a finding of *scienter*; (4) whether its operation will promote the traditional aims of punishment-retribution and deterrence; (5) whether the behavior to which it applies is already a crime; (6) whether an alternative purpose to which it may rationally be connected is assignable for it; and (7) whether it appears excessive in relation to the alternative purpose assigned.[148]

Legislative intent is entitled to judicial deference; "'only the clearest proof' will suffice to override legislative intent and transform what has been denominated a civil remedy into a criminal penalty."[149]

The Exchange Act provides for a regulatory system of civil sanctions, and FINRA consistently describes its sanctions as remedial.[150] Therefore, FINRA sanctions are presumed to be civil remedies, yet a too-severe sanction may be deemed punitive. The question remains: what is the distinction between kicking someone out of the industry as punishment and kicking someone out as a remedial sanction? A sanction imposed for the purpose of punishing someone for past conduct, as retribution for a wrong or just deserts, is unquestionably punitive in nature.[151] Sanctions imposed to compensate the government for a loss (restitution),[152] or disgorgement of ill-gotten gains,[153] by contrast, are unquestionably remedial. Deterrence as a rationale is less clear. Traditionally, sanctions imposed as deterrence were generally viewed as punitive.[154] The modern view, however, is to

147. *Id.* at 99 (quoting Rex Trailer Co. v. United States, 350 U.S. 148, 154 (1956)).

148. *Hudson*, 522 U.S. at 100 (quoting Kennedy v. Mendoza-Martinez, 372 U.S. 144, 168–69 (1963)) (internal quotation marks omitted). In *Mendoza-Martinez*, the Court found that a statute taking away U.S. citizenship for evading military service was punitive based on congressional descriptions of the purpose of the statute. 372 U.S. at 186.

149. *Hudson*, 522 U.S. at 100 (quoting United States v. Ward, 448 U.S. 242, 249 (1980)).

150. *See infra* notes 178–181.

151. *Mendoza-Martinez*, 372 U.S. 144. In ruling that a state statute requiring registration of convicted sex offenders was non-punitive and therefore did not violate the ex post facto clause, the Supreme Court acknowledged that public shaming as the motive for sanctions may raise constitutional problems. Smith v. Doe, 538 U.S. 84, 102 (2003).

152. United States v. Bajakajian, 524 U.S. 321, 334 (1998) (establishing a gross proportionality test for determining if forfeiture would violate the excessive fines clause).

153. Sweeney, Exchange Act Release No. 29,884, 1991 WL 716756, at *5 (Oct. 30, 1991) (stating that, generally, disgorgement should be ordered in all cases in which the SRO can identify direct financial gain obtained as a result of wrongful activity, in order to remedy past wrongs and deter future misconduct). Disgorgement amounts must be approximately equal to the unjust enrichment or else they are unreasonable and excessive. Hateley v. SEC, 8 F.3d 653, 656 (9th Cir. 1993).

154. *Bajakajian*, 524 U.S. at 329. In Johnson v. SEC, 87 F.3d 484, 488 (D.C. Cir. 1996), the court held that a "penalty," as the term is used in the statute of limitations for government

distinguish between general and specific deterrence. Specific deterrence is recognized as remedial, serving to protect the public by removing the person from the industry.[155] General deterrence is also recognized as an appropriate factor to take into consideration, at least where the offense was egregious.[156] General deterrence, however, is not appropriate without specific deterrence; it is not permissible to make an example of someone who does not otherwise warrant specific deterrence.[157] Accordingly, a bar, expulsion, or long-term suspension is considered remedial so long as there are reasons as to why the sanction serves to protect the trading public from future harm.[158]

In reviewing SEC orders imposing sanctions,[159] courts recognize that they should not ordinarily substitute their judgment for the agency's as to measures necessary to protect the public interest because "the relation of remedy to policy is peculiarly a matter for administrative competence."[160] Nevertheless, courts do more than rubber-stamp the SEC order, and, at least in instances of a bar or long-term suspension, courts will consider whether the sanction is appropriately remedial and not punitive.[161] *Steadman v.*

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sanctions, is a form of punishment that goes beyond remedying the damage caused by the harmful conduct.

155. McCurdy v. SEC, 396 F.3d 1258, 1264–65 (D.C. Cir. 2005) (rejecting argument that a one-year suspension against a certified public accountant was punitive because it was based on his past reckless conduct, finding it "difficult to imagine how *any* suspension, remedial or not, could be based on anything but past actions," and making it clear that the purpose of the suspension was to protect the public); Wright v. SEC, 112 F.2d 89, 94 (2d Cir. 1940) (rejecting argument that proof beyond a reasonable doubt was required to expel member). A six-month disciplinary suspension "would less resemble punishment if the SEC had focused on [the individual's] current competence or the degree of risk she posed to the public." *Johnson*, 87 F.3d at 489.

156. Steadman v. SEC, 603 F.2d 1126, 1140 (5th Cir. 1979) (requiring SEC to articulate compelling reasons for permanent expulsion, e.g., that violation is so egregious that it mandates permanent expulsion as a deterrent to others); Busacca v. SEC, 449 Fed. App'x 886, 893 (11th Cir. 2011) (rejecting argument that SEC's acknowledged aim of encouraging other supervisors to respond to operational problems was impermissibly punitive).

157. PAZ Sec., Inc. v. SEC, 494 F.3d 1059, 1066 (D.C. Cir. 2007) (quoting and agreeing with Second Circuit's statement on general deterrence); McCarthy v. SEC, 406 F.3d 179, 189 (2d Cir. 2005) (stating that general deterrence is not sufficient justification for expulsion or suspension, although it may be considered as part of the overall remedial inquiry); Beck v. SEC, 430 F.2d 673, 674–75 (6th Cir. 1970) (holding that four-month suspension was punitive where it did not appear that the broker would be inclined to commit any further misconduct).

158. Ricupero v. SEC, 436 Fed. App'x 31, 33 (2d Cir. 2011) (quoting *McCarthy*, 406 F.3d at 188) (In reviewing an SEC order sustaining SRO sanctions, the foremost consideration is whether it "protects the trading public from further harm.").

159. Courts do not draw a distinction between SEC orders that originated within the SEC (through an ALJ) or originated with an SRO, since an agency's review of an SRO order is de novo and it must make the requisite findings. *See supra* notes 39–41.

160. O'Leary v. SEC, 424 F.2d 908, 911 (D.C. Cir. 1970). The courts acknowledge that there is considerable discretion in determining the appropriate sanction, recognizing only that "[*p*]*erhaps* gross disparities in sanctions for similar behavior would at least suggest underlying bias." D'Alessio v. SEC, 380 F.3d 112, 125 (2d Cir. 2004) (emphasis added).

161. *E.g.*, Steadman v. SEC, 603 F.2d 1126, 1141 (5th Cir. 1979).

SEC,[162] a frequently cited case, lists factors that essentially amount to a prediction about whether the person is likely to engage in misconduct in the future:

> [1] the egregiousness of the defendant's actions, [2] the isolated or recurrent nature of the infraction, [3] the degree of scienter involved, [4] the sincerity of the defendant's assurances against future violations, [5] the defendant's recognition of the wrongful nature of his conduct, and [6] the likelihood that the defendant's occupation will present opportunities for future violations.[163]

Another frequently cited opinion, *McCarthy v. SEC*,[164] identified as relevant factors: "[t]he seriousness of the offense, the corresponding harm to the trading public, the potential gain to the broker for disobeying the rules, the potential for repetition in light of the current regulatory and enforcement regime, and the deterrent value to the offending broker and others."[165] Other courts state more generally that sanctions are punitive if they are too severe or draconian.[166] What the courts require is that the SEC considered the facts and circumstances of the particular case, made the requisite findings of a violation, and articulated reasons why the sanction is appropriate for the particular violation. Courts have criticized boilerplate findings of wrongdoing[167] and do not find it sufficient if the agency merely stated, in effect, that the conduct was illegal or that the individual in question was a bad person.[168] Courts have vacated SEC orders for failing to address mitigating factors advanced by the individual to reduce the sanction.[169] Courts are especially concerned where the SEC has upheld a permanent bar, since it amounts to termination of a professional career.[170]

Courts often identify lack of remorse by the violator and substantial losses to investors, particularly unsophisticated customers, as important factors in upholding bars.[171] Instances where a bar was upheld because of findings of egregious conduct include:

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162. *Id.* at 1140.

163. *Id.* (noting that these are the factors deemed relevant to the issuance of an injunction).

164. McCarthy v. SEC, 406 F.3d 179, 190 (2d Cir. 2005).

165. *Id.*

166. *E.g.*, D'Alessio v. SEC, 380 F.3d 112, 124 (2d Cir. 2004).

167. *McCarthy*, 406 F.3d at 189 (finding it suggestive that the SEC did not devote individual attention to the unique facts and circumstances of the case).

168. *Id.* at 188; Blinder, Robinson & Co. v. SEC, 837 F.2d 1099, 1113 (D.C. Cir. 1988).

169. Saad v. SEC, 718 F.3d 904, 914 (D.C. Cir. 2013).

170. *Id.* at 906 (quoting PAZ Sec., Inc. v. SEC, 494 F.3d 1059, 1065 (D.C. Cir. 2007)) (describing a lifetime bar as "'the securities industry equivalent of capital punishment'"); *see also Blinder*, 837 F.2d at 1113 ("Faced with a task of such gravity, the Commission must craft with care."). Courts have rejected, however, arguments that the SEC can impose a permanent bar only if it makes findings explaining why a lesser sanction is not sufficient. Paz Sec., Inc. v. SEC, 566 F.3d 1172, 1176 (D.C. Cir. 2009); Rizek v. SEC, 215 F.3d 157, 161 (1st Cir. 2000).

171. Failure to express remorse may be more common in cases where the brokers are not represented by counsel, as is frequently the case in disciplinary proceedings.

- Broker showed no remorse, customers were unsophisticated, and losses were substantial;[172]
- Broker did not acknowledge wrong, blamed others (including customer), and engaged in ongoing deception;[173] and
- Broker engaged in a pattern of wrongdoing and harm to retail customers.[174]

In contrast, examples of impermissible, "draconian" penalties include:

- An uncertain regulatory environment;[175]
- Non-frivolous claim of "systemic pattern of disparate treatment" against newer, smaller firms that resulted in "predictably, disproportionately harsh sanctions;"[176] and
- Individual has been engaged in the industry without further trouble since the misconduct.[177]

B. THE PRACTICE OF FINRA'S SANCTIONS

In the preceding section, we looked at the theory and law of FINRA's sanctions as developed in the case law. In this section, we look at the practice of FINRA's sanctions.

First and foremost, FINRA articulates as a fundamental principle that its sanctions are remedial.[178] Thus, for example, statements by FINRA CEO Richard G. Ketchum consistently emphasize that a strong enforcement program is for the protection of investors and do not speak in terms of punishing violators.[179] Similarly, a former NYSE regulator (prior to the

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172. *Rizek*, 215 F.3d at 159–60 (churning in accounts of five customers).

173. Otto v. SEC, 253 F.3d 960, 962 (7th Cir. 2001) (misuse of a customer's funds for his personal use).

174. Gonchar v. SEC, 409 Fed. App'x 396, 399 (2d Cir. 2010) (excessive undisclosed markups to retail customers).

175. *Blinder*, 837 F.2d at 1112 (antifraud and antimanipulation violations in underwriting penny stock offerings); Arthur Lipper Corp. v. SEC, 547 F.2d 171, 175 (2d Cir. 1976) (payment of give-ups); *see also* Upton v. SEC, 75 F.3d 92, 98 (2d Cir. 1996) (vacating an SEC order because of insufficient notice that the SEC considered the firm's practice a violation of its customer protection rule).

176. *Blinder*, 837 F.2d at 1112.

177. McCarthy v. SEC, 406 F.3d 179, 189 (2d Cir. 2005) (floor trading violations); Beck v. SEC, 430 F.2d 673, 674 (6th Cir. 1970) (misrepresentations to customers in connection with sales of a security).

178. FINRA, SANCTION GUIDELINES 4 (2011) [hereinafter FINRA, SANCTION GUIDELINES], *available at* http://www.finra.org/web/idcplg?IdcService=SS_GET_PAGE&ssDocName =p011038.

179. *See, e.g.*, News Release, FINRA, 2012: FINRA Year in Review (Jan. 8, 2013), *available at* http://www.finra.org/Newsroom/NewsReleases/2013/P197624 ("Protecting investors and helping to ensure the integrity of the nation's financial markets is at the heart of what we do every day."); *see also* Letter from Richard G. Ketchum, Chairman & CEO, FINRA, *in* FINRA, FINRA 2010 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT 2–3 (2011), *available at*

consolidation) stated that "[t]he Exchange does not frame its regulatory proceedings in terms of punishment."[180] FINRA's *Sanction Guidelines* (the *Guidelines*) also emphasize the remedial purpose of sanctions, as is discussed shortly.[181]

Second, it is important to keep in mind that very few of FINRA's sanctions are imposed after a disciplinary hearing; consequently, the number of sanctions that are reviewed even by the NAC is small. This is true even with respect to the most severe sanctions. A review of the monthly FINRA disciplinary actions for 2008 showed a total of 274 disciplinary actions imposing bars, of which over two-thirds were settled.[182] Another twenty-five percent were default decisions.[183] Only in sixteen reported disciplinary actions imposing a bar was a hearing conducted in which respondents contested the charges, and in many of them respondents appeared pro se.[184] There were another thirteen reported actions imposing a two-year suspension, only two of which involved hearings where respondents contested the charges.[185] Of the eighteen reported decisions, the highest ultimate adjudicator in each instance was as follows: one was a

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http://www.finra.org/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=P123836; Letter from Richard G. Ketchum, Chairman & CEO, FINRA (2010), *available at* http://www.finra.org/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=P121646.

180. Susan Merrill et al., *Sharper and Brighter: Focusing on Sanctions at the New York Stock Exchange*, 3 N.Y.U. J.L. & BUS. 155, 169 (2006).

181. *See infra* notes 198–205 and accompanying text; *see also* FINRA, SANCTION GUIDELINES, *supra* note 178, at 4.

182. FINRA's 2008 disciplinary actions are reported on its website. *2008 Monthly & Quarterly Disciplinary Actions*, FINRA, http://www.finra.org/Industry/Enforcement/DisciplinaryActions/MonthlyActions/2008/ (last visited Nov. 17, 2013).

183. *See id.*

184. *See id.*

185. Four were concluded by Letters of Acceptance, Waiver, or Consent; seven were concluded by Offers of Settlement.

judicial decision,[186] seven were SEC decisions,[187] four were NAC decisions,[188] and six were hearing panel decisions.[189]

Failure to contest the charges or to retain legal representation is not surprising since a firm is likely to terminate the employment of an associated person who is charged with a serious violation, and that individual is not likely to have a bright future in the industry unless he is a very successful salesperson. A recent empirical study, however, shows that respondents who proceed to a hearing frequently persuade the hearing panel to impose lower sanctions than the staff offered in settlement.[190]

186. Gonchar v. SEC, 409 Fed. App'x 396, 400–01 (2d Cir. 2010) (denying petition for review of SEC order sustaining sanctions imposed by the NASD for petitioner's violations of the Exchange Act).

187. CMG Inst. Trading, LLC, Exchange Act Release No. 59,325, 2009 WL 223617, at *11 (Jan. 30, 2009) [hereinafter CMG Release] (sustaining findings of violations and sanctions); Epstein, Exchange Act Release No. 59,328, 2009 WL 223611, at *21 (Jan. 30, 2009) [hereinafter Epstein Release] (sustaining findings of violations and sanctions); Ortiz, Exchange Act Release No. 58,416, 2008 WL 3891311, at *10 (Aug. 22, 2008) [hereinafter Ortiz Release] (sustaining findings of violations and sanctions); Craig, Exchange Act Release No. 59,137, 2008 WL 5328784, at *8 (Dec. 22, 2008) [hereinafter Craig Release] (sustaining findings of violations and sanctions); Pellegrino, Exchange Act Release 59,125, 2008 WL 5328765, at *18 (Dec. 19, 2008) [hereinafter Pellegrino Release] (sustaining findings of violations and sanctions); Audifferen, Exchange Act Release No. 58,230, 2008 WL 2876502, at *16 (July 25, 2008) [hereinafter Audifferen Release] (sustaining findings of violations and sanctions); Fawcett, Exchange Act Release No. 56,770, 2007 WL 3306105, at *8 (Nov. 8, 2007) [hereinafter Fawcett Release] (sustaining findings of violations and sanctions).

188. Dep't of Enforcement v. Zaragoza, Complaint No. E8A2002109804, 2008 WL 3915716, (FINRA NAC Aug. 20, 2008) [hereinafter Zaragoza Complaint] (affirming findings and sanctions); Dep't of Enforcement v. Dunbar, Complaint No. C07050050, 2008 WL 2167905, (FINRA NAC May 20, 2008) [hereinafter Dunbar Complaint] (affirming findings and modifying sanctions); Dep't of Enforcement v. Nicolas, Complaint No. CAF040052, 2008 WL 696458, (FINRA NAC Mar. 12, 2008) [hereinafter Nicolas Complaint] (affirming in part findings and affirming sanctions); Dep't of Enforcement v. Paratore, Complaint No. 2005002570601, 2008 WL 696457, (FINRA NAC Mar. 7, 2008) [hereinafter Paratore Complaint] (modifying findings in part and affirming sanctions).

189. Dep't of Enforcement v. Hodge, Discip. Proceeding No. 2006003995001, 2008 FINRA Discip. LEXIS 52 (FINRA OHO Oct. 1, 2008) [hereinafter Hodge Discip. Proceeding]; Dep't of Enforcement v. Varone, Discip. Proceeding No. 2006007101701, 2008 FINRA Discip. LEXIS 55 (FINRA OHO Aug. 20, 2008) [hereinafter Varone Discip. Proceeding]; Dep't of Enforcement v. Selewach, Discip. Proceeding No. 2006005005301, 2008 FINRA Discip. LEXIS 5 (FINRA OHO Feb. 20, 2008) [hereinafter Selewach Discip. Proceeding]; Dep't of Enforcement v. Hansen, Discip. Proceeding No. 2005001085001, 2008 FINRA Discip. LEXIS 2 (FINRA OHO Jan. 10, 2008) [hereinafter Hansen Discip. Proceeding]; Dep't of Enforcement v. Mattes, Discip. Proceeding No. 2006005936701, 2007 FINRA Discip. LEXIS 9 (FINRA OHO Nov. 6, 2007) [hereinafter Mattes Discip. Proceeding]; Dep't of Enforcement v. Behany, Discip. Proceeding No. E9B2003026301, 2007 NASD Discip. LEXIS 17 (NASD OHO Mar. 20, 2007) [hereinafter Behany Discip. Proceeding].

190. Brian L. Rubin & Jae C. Yoon, *Stepping into the Ring Against the SEC and FINRA: Sometimes It Pays to Duke It Out Against the Regulators*, 40 SEC. REG. L.J. 485 (2012). During the time period, when FINRA staff sought an industry bar, "75% of [respondents] convinced a Hearing Panel to impose a lesser sanction." *Id.* at 489. FINRA respondents with a lawyer also fared significantly better than pro se respondents; during the time period, pro se respondents were uniformly unsuccessful. *Id.* at 494 n.16.

Because few disciplinary sanctions are imposed after a formal hearing and fewer still are subject to any level of appeal, there is only a small body of NAC decisions analyzing the factors to take into account in determining appropriate sanctions, hence the importance of FINRA's *Sanction Guidelines*, which the NAC developed for use by hearing panels and the NAC to determine appropriate sanctions and to promote consistency and uniformity.[191] Consistent with the "facts and circumstances" approach generally followed,[192] the *Guidelines* do not prescribe fixed sanctions for particular violations, but instead are intended "to provide direction for Adjudicators in imposing sanctions consistently and fairly,"[193] and adjudicators have discretion to impose sanctions that fall outside the recommended ranges.[194] The *Guidelines* set forth aggravating and mitigating factors for adjudicators to take into account and permit adjudicators to consider other aggravating and mitigating factors as well.[195] The value of the *Guidelines* is that they focus the attention of the adjudicators on relevant considerations, and to the extent the factors focus on remediation, the *Guidelines* may act as a curb on the natural tendency to punish wrongdoers. Courts have cited with approval the SEC's references to the *Guidelines* in its consideration of appropriate sanctions.[196] Indeed, the D.C. Circuit recently vacated an SEC order affirming a NASD permanent

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191. FINRA, SANCTION GUIDELINES, *supra* note 178, at 1. NASD first published the *Sanction Guidelines* in 1993, and they are regularly revised. *March 2006 Revisions*, *supra* note 12 (answer to question 1). The NAC "possesses ultimate authority with respect to the Sanction Guidelines." *Id.*

192. FINRA, SANCTION GUIDELINES, *supra* note 178, at 1, 3, 4. FINRA, however, has established a bar as the standard sanction for three violations: failure to respond to a FINRA inquiry or investigation, conversion of a customer's funds or securities, and cheating on qualifications examinations. *See infra* notes 206, 208 and accompanying text.

193. FINRA, SANCTION GUIDELINES, *supra* note 178, at 1. By contrast, the Exchange Act authorizes the SEC to impose a civil penalty if the agency finds that it is in the public interest and that the person has committed a willful offense or failed reasonably to supervise another person. 15 U.S.C. § 78u-2(b) (2012). The statute then sets forth a three-tier structure for determining monetary penalties in SEC administrative proceedings and federal district court proceedings brought by the SEC. *Id.* § 78u(d)(3). The third tier provides for the maximum amount of penalties and thus identifies the most serious types of offenses. To impose third-tier penalties, the adjudicator must find that the violation involved at least reckless disregard of a regulatory requirement and resulted in substantial losses, or created a significant risk of substantial losses, to other persons or resulted in substantial pecuniary gain to the violator. *Id.* §§ 78u(d)(3)(B)(iii), 78u-2(b)(3). If adopted by FINRA, these factors could provide more concrete guidance as to what constitutes "egregious" conduct. The statute also sets forth a non-exclusive list of factors the SEC may consider in deciding whether a penalty is in the public interest: whether the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of regulatory requirements; the harm to other persons resulting from the violation; the extent to which any person was unjustly enriched, taking into account any restitution made to the injured persons; whether the person is a recidivist; and the need to deter such person and other persons. *Id.* § 78u-2(c).

194. FINRA, SANCTION GUIDELINES, *supra* note 178, at 1.

195. *Id.*

196. Stoiber v. SEC, 161 F.3d 745, 753 (D.C. Cir. 1998).

bar because it failed to address all of the mitigating factors raised by the associated person, including, in particular, a factor expressly identified in the *Guidelines* as mitigating.[197]

The *Guidelines* contain general principles that should be considered in all cases as well as specific considerations for common violations (the General Principles). Beginning with the First Principle, the *Sanction Guidelines* convey a message that FINRA sanctions are "remedial":

> **Disciplinary sanctions are remedial in nature and should be designed to deter future misconduct and to improve overall business standards in the securities industry.** The overall purposes of FINRA's disciplinary process and FINRA's responsibility in imposing sanctions are to remediate misconduct by preventing the recurrence of misconduct, improving overall standards in the industry, and protecting the investing public. Toward this end, Adjudicators should design sanctions that are significant enough to prevent and discourage future misconduct by a respondent, to deter others from engaging in similar misconduct, and to modify and improve business practices.[198]

Similarly, other statements in the General Principles set forth purposes that courts have recognized as appropriately remedial.[199] Thus, adjudicators are encouraged to design sanctions to prevent the recurrence of misconduct.[200] In order to remediate misconduct, adjudicators should order restitution and/or rescission[201] and should take into account a respondent's ill-gotten gain in determining fines.[202] Requiring a violator to requalify in any or all capacities is an appropriate sanction when adjudicators have found that his actions demonstrated a lack of knowledge or familiarity with the rules of the securities industry.[203]

The literature on sanctions recognizes that regulators may appropriately impose sanctions to induce compliance with the rules and to deter misconduct by raising the cost of violation above the cost of compliance.[204]

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197. Saad v. SEC, 718 F.3d 904, 913 (D.C. Cir. 2013); *see also* PAZ Sec., Inc. v. SEC, 494 F.3d 1059, 1065 (D.C. Cir. 2007) (stating that the SEC must carefully consider potentially mitigating factors, especially when the associated person faces a lifetime bar).

198. FINRA, SANCTION GUIDELINES, *supra* note 178, at 2 (General Principle 1).

199. *Id.* at 4.

200. *Id.* at 3 (General Principle 3). Examples include requiring a consultant to design or implement compliance procedures and requiring a firm to implement heightened supervision of certain individuals or departments. *Id.*

201. *Id.* at 4 (General Principle 5). Adjudicators may order restitution when an identifiable person "has suffered a quantifiable loss proximately caused by respondent's misconduct." *Id.* Without causation, however, a restitution sanction is arbitrary and non-remedial. *See* Siegel v. SEC, 592 F.3d 147, 161–62 (D.C. Cir. 2010).

202. FINRA, SANCTION GUIDELINES, *supra* note 178, at 5 (General Principle 6).

203. *Id.* at 5 (General Principle 7).

204. The classic economic analysis of this is Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968). For a recent discussion of its application to securities offenses, see Samuel W. Buell, *Liability and Admissions of Wrongdoing in Public*

Under this approach, an important factor for the regulator to take into account in determining sanctions is the difficulty in detecting violations.[205] This factor, however, is not mentioned as a consideration in the *Sanction Guidelines* and is not discussed in the opinions, perhaps because FINRA does not want to suggest that some violations are difficult to detect.

FINRA explains that, in determining if a violation is egregious, adjudicators "assess the individual facts and circumstances of the case" and "also consider all relevant aggravating and mitigating factors."[206] FINRA does not attempt to define "egregious," but the dictionary definition of "[e]xtremely or remarkably bad" provides a working definition consistent with the *Sanction Guidelines*.[207] Thus, the *Sanction Guidelines* identify factors that can lead to a finding of egregious conduct: repeated instances of wrongful conduct;[208] the violator's motives, e.g., bad faith[209] and intentional misconduct;[210] significant injury to customers[211] and activity involving numerous customers;[212] and failures to meet compliance requirements for extended periods of time.[213] The *Sanction Guidelines* frequently refer to factors that go to mens rea, scienter, and prior disciplinary history.[214] Thus, the General Principles state that "sanctions should be more severe for recidivists."[215] Similarly, the *Guidelines* identify a number of factors that may be mitigating or aggravating, as the case may be,[216] many of which also go to mens rea, including repentance (especially prior to detection),[217] lack of remorse and concealment,[218] and intent/culpability.[219] Although the emphasis on mens rea suggests an intention to punish, these factors can also be described as remedial since they address the need to protect the general

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Enforcement of Law, 81 U. CIN. L. REV. (forthcoming 2013), *available at* http://ssrn.com/abstract=2230396 (describing the deterrent effect of sanctions).

205. *See* Minzner, *supra* note 136, at 877–78 (citing the literature).

206. *March 2006 Revisions*, *supra* note 12 (answer to question 17). The website explains that adjudicators have "wide discretion" in determining sanctions. *Id.* (answer to question 7).

207. BLACK'S LAW DICTIONARY 593 (9th ed. 2009). In the case law under Rule 10b-5, "egregious" conduct generally connotes at least reckless conduct. *See, e.g.*, *In re* Livent, Inc. Noteholders Sec. Litig., 151 F. Supp. 2d 371, 418–22 (S.D.N.Y. 2001) (discussing pleading standard under the Private Securities Litigation Reform Act).

208. FINRA, SANCTION GUIDELINES, *supra* note 178, at 98 n.2 (categories of egregious unauthorized trading); *id.* at 13 (outside activities including selling away); *id.* at 39 (failure to register).

209. *Id.* at 98 n.2 (egregious unauthorized trading).

210. *Id.* at 41 (failure to comply with continuing education requirements).

211. *Id.* at 13 (outside activities including selling away).

212. *Id.* at 82 (failure to comply with risk disclosure requirements for day trading accounts).

213. *Id.* at 64 (failure to comply with TRACE reporting requirements).

214. *See id.* at 4–6.

215. *Id.* at 2.

216. *Id.* at 6–7.

217. *Id.* at 2–4.

218. *See id.* at 6.

219. *See id.* at 4, 7.

investing public from an individual who has shown himself to be a "bad apple."

By contrast, the Exchange Act provides somewhat more guidance for the imposition of civil penalties in SEC actions. The statute authorizes the SEC to impose a civil penalty if the agency finds that it is in the public interest and that the person has committed a willful offense or failed reasonably to supervise another person.[220] The statute then sets forth a three-tier structure for determining monetary penalties in SEC administrative proceedings[221] and in federal district court proceedings brought by the SEC.[222] The third tier provides for the maximum amount of penalties and thus identifies the most serious types of offenses. To impose third-tier penalties, the adjudicator must find that the violation involved at least reckless disregard of a regulatory requirement and resulted in substantial losses, or created a significant risk of substantial losses, to other persons or resulted in substantial pecuniary gain to the violator.[223] If adopted by FINRA, these factors could provide more concrete guidance as to what constitutes "egregious" conduct. The statute also sets forth a non-exclusive list of factors the SEC may consider in deciding whether a penalty is in the public interest: whether the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of regulatory requirements; the harm to other persons resulting from the violation; the extent to which any person was unjustly enriched, taking into account any restitution made to the injured persons; whether the person is a recidivist; and the need to deter such person and other persons.[224] These factors are similar to those identified in the *Sanction Guidelines*.

Two other factors set forth in the *Sanction Guidelines* are also worthy of mention. Firm size and the ability to pay are considerations that do not seem relevant in assessing whether sanctions are appropriately remedial. Congress, however, identified the violator's ability to pay a civil penalty as an important consideration when in 1990 it authorized, for the first time, the SEC to impose monetary penalties,[225] and the Small Business Regulatory Enforcement Fairness Act of 1996 requires federal agencies to establish a policy to provide for the reduction or waiver of civil penalties for small entities.[226] In 1996, the SEC vacated a NASD restitution order because its refusal to consider evidence of financial inability to pay was unduly

220. 15 U.S.C. § 78u-2(b) (2012).

221. *Id.*

222. *Id.* § 78u(d)(3).

223. *Id.* §§ 78u(d)(3)(B)(iii), 78u-2(b)(3).

224. *Id.* § 78u-2(c).

225. *Id.* § 78u-2(d); *see also* Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104. Stat. 931; SECURITIES LAW ENFORCEMENT REMEDIES ACT OF 1990, H.R. REP. NO. 101-616, at 21 (1990), *reprinted in* 1990 U.S.C.C.A.N. 1379, 1388.

226. Small Business Regulatory Enforcement Act of 1996, Pub. L. No. 104-121, § 223, 110 Stat. 857, 862.

harsh.[227] As a result of these directives from Congress and the SEC, the *Guidelines* instruct adjudicators to consider firm size to ensure that the sanctions are "not punitive but are sufficiently remedial to achieve deterrence."[228] The *Guidelines* also explicitly state that the SEC requires adjudicators to consider ability to pay in connection with the imposition, reduction, or waiver of a fine or restitution when the respondent raises the issue.[229] The *Guidelines*, while stating generally that adjudicators should consider firm size, also draw a distinction between sanctions imposed for violations based on negligent conduct and those based on fraudulent, willful, or reckless conduct. In the latter instances, adjudicators are permitted not to take into account firm size.[230]

A second important factor that does relate to a remedial purpose is compliance. The *Guidelines* emphasize the importance of compliance. Thus, adjudicators may appropriately consider:

- "Whether, at the time of the violation, the . . . firm had developed reasonable supervisory, operational and/or technical procedures or controls that were properly implemented;"[231]
- "Whether, at the time of the violation, the firm had developed adequate training and educational initiatives;"[232]
- "Whether the respondent demonstrated reasonable reliance on competent legal or accounting advice;"[233] and
- Whether the firm can demonstrate that the conduct was "not otherwise reflective of the firm's historical compliance record."[234]

Because regulatory standards require compliance systems for investor protection and because compliance systems are expensive, these factors identify important remedial purposes.

Finally, despite FINRA's emphasis on the facts and circumstances of the inquiry, there are three violations where a bar is standard. These are:

- Individuals who fail to respond in any manner to FINRA inquiry or investigation.[235] Because FINRA does not have subpoena power, this is a violation of the fundamental nature of self-regulation; lack

227. Reed, Exchange Act Release No. 37,572, 1996 WL 466575, at *2 (Aug. 14, 1996).

228. FINRA, SANCTION GUIDELINES, *supra* note 178, at 2. General Principle 8 requires adjudicators to consider ability to pay when raised by a respondent. *Id.* at 5.

229. *Id.* at 5.

230. *Id.* at 2 n.2.

231. *Id.* at 6.

232. *Id.*

233. *Id.*

234. *Id.* at 7.

235. *See id.* at 33. Where mitigation exists, suspension in any or all capacities for up to two years is suggested.

of harm to customers or benefit to the violator does not mitigate this violation.[236]

- Conversion of a customer's funds or securities, regardless of amount converted.[237] More than any other violation, this offense damages the public's confidence in the broker-dealer relationship.
- Cheating on qualifications exams.[238] An individual who gained entry through cheating should not be allowed to continue in the industry.

As described earlier, a review of the FINRA 2008 Monthly and Quarterly Disciplinary Actions found eighteen decisions where a bar or a two-year suspension was imposed.[239] Many of the violations that resulted in a bar were those for which a bar is standard. Thus, five of eighteen decisions imposed a bar on an individual for failure to respond to a FINRA inquiry or investigation;[240] another three imposed a bar for conversion of customers' funds.[241] Bars or a two-year suspension were also imposed for other forms of simple fraud or obvious wrongdoing, such as failure to disclose one's criminal record on the Form U-4,[242] forgery,[243] misuse of customer's funds,[244] excessive trading in a customer's account,[245] trading ahead of a customer,[246] or interpositioning.[247] Many decisions note as aggravating factors the willful or intentional nature of the conduct,[248] the failure to acknowledge responsibility for wrongdoing,[249] substantial harm to customers,[250] and taking advantage of vulnerable customers.[251] Youth and inexperience were not accepted as mitigating factors.[252] Dishonest conduct

236. *Id.* at 2 n.2.

237. *Id.* at 36.

238. *Id.* at 40.

239. *See supra* notes 187–189 and accompanying text.

240. Ortiz Release, *supra* note 187; Fawcett Release, *supra* note 187; Hodge Discip. Proceeding, *supra* note 189; Varone Discip. Proceeding, *supra* note 189; Hansen Discip. Proceeding, *supra* note 189. In one administrative proceeding, a NASD member firm and its CEO received two-year suspensions for failure to respond in a timely fashion. CMG Release, *supra* note 187.

241. Paratore Complaint, *supra* note 188; Selewach Discip. Proceeding, *supra* note 189; Mattes Discip. Proceeding, *supra* note 189.

242. Craig Release, *supra* note 187.

243. Ortiz Release, *supra* note 187.

244. Varone Discip. Proceeding, *supra* note 189.

245. Zaragoza Complaint, *supra* note 188.

246. Nicolas Complaint, *supra* note 188.

247. Gonchar v. SEC, 409 Fed. App'x 396, 399 (2d Cir. 2010).

248. Ortiz Release, *supra* note 187; Audifferen Release, *supra* note 187.

249. Ortiz Release, *supra* note 187, at *8; Audiffern Release, *supra* note 187, at *14. In one decision two brokers received two-year suspensions because they accepted responsibility, while another was barred for failure to do so. Behany Discip. Proceeding, *supra* note 189.

250. Nicolas Complaint, *supra* note 188.

251. Zaragoza Complaint, *supra* note 188; Mattes Discip. Proceeding, *supra* note 189.

252. Epstein Release, *supra* note 187, at *21.

was not excused because it was done for the purpose of benefitting the customer.[253]

CONCLUSION

Part I documents the transformation of the securities SRO from a membership organization with contractual powers to require its members to adhere to aspirational standards to a professional regulator that derives its powers from the Exchange Act. Part II explores the tenuous distinction between remedial and punitive sanctions and describes FINRA's current system for disciplining its members and associated persons. This is a system that, to date, has operated largely under the radar without much academic scrutiny.

253. Behany Discip. Proceeding, *supra* note 189 (improperly obtaining CDSC waivers for customers; two brokers who accepted responsibility received two-year suspensions).