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MEMO# 25544

October 6, 2011

US Court of Appeals Holds That FINRA Lacks Authority to Bring Court Actions to Enforce its Fines

[25544]

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TO: BROKER/DEALER ADVISORY COMMITTEE No. 63-11
COMPLIANCE MEMBERS No. 41-11
SEC RULES MEMBERS No. 118-11 RE: US COURT OF APPEALS HOLDS THAT FINRA LACKS AUTHORITY TO BRING COURT ACTIONS TO ENFORCE ITS FINES

The U.S. Court of Appeals held in a decision issued yesterday that FINRA [f/k/a NASD] lacks lawful authority to bring court actions to enforce the fines it imposes against members. [1] The facts of this case and the court's reasoning for this holding are briefly summarized below.

Background

The Plaintiffs in this case are a New York broker-dealer and its sole registered representative, who were sanctioned by the NASD's Department of Enforcement in 2000 based upon violations of Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, and FINRA conduct rules. Based on these violations, the Plaintiff broker-dealer was expelled from membership in FINRA, the Plaintiff registered representative was barred from associating with any FINRA members, and they were fined jointly and severally $1,000,000 plus costs. When the Plaintiffs refused to pay the fine, FINRA sued to collect it in the New York Supreme Court.

Lower Courts' Decisions

In 2005, the New York Supreme Court upheld the NASD's claim finding that the Plaintiffs, as members of the NASD, had expressly agreed to comply with all NASD rules, "including the imposition of fines and sanctions." On appeal, the First Department of the New York Appellate Division affirmed the Supreme Court's decision and granted the Plaintiffs leave to appeal. On appeal, the court reversed the decision on the ground that the state courts lacked subject matter jurisdiction because the fine had been imposed by FINRA under authority granted to it by the Securities Exchange Act 1934. As such, jurisdiction over the matter fell within the exclusive jurisdiction of the federal courts.

In 2008, the day after the New York Court of Appeals issued its holding, the Plaintiffs filed suit in federal court seeking a declaratory judgment that FINRA has no legal authority to collect fines through judicial proceedings. FINRA filed a counterclaim seeking to enforce the fine through a breach of contract theory. In March 2009, the U.S. District Court granted FINRA's motion to dismiss the Plaintiffs' claim and denied the Plaintiffs' motion to dismiss FINRA's counterclaim. The court's clerk was instructed to enter judgment in favor of FINRA. The case was then appealed to the U.S. Court of Appeals, which reversed the District Court's decision for the reasons discussed below.

The Court of Appeals Decision

The Court of Appeals reviewed the legality of FINRA's judicial action to collect the fine based on FINRA's authority under the Exchange Act and under a 1990 rule it had adopted that authorized such actions.

FINRA's Authority Under the Exchange Act

According to the court, the first question raised by the appeal is whether the Exchange Act provides FINRA with the necessary authority to bring a judicial proceeding to collect its fines. The court reviewed the language of Section 15A(b) of the Act, which authorizes FINRA to appropriately discipline its members through expulsion; suspension; limitation of activities, functions, and operations; fines; censure; being suspended or barred from being associated with a member; or any other fitting sanction. However, as noted by the court, "there is no express statutory authority for SRO's (sic) to bring judicial actions to enforce the collection of fines." [2] It noted that, the core issue underlying this matter is congressional intent. In the court's view, based on its analysis of congressional intent, "Congress did not intend to empower FINRA to bring judicial actions to enforce its fines." [3]

According to the court, "there are no explicit provisions in the statute authorizing SRO's (sic) to seek judicial enforcement of the variety of sanctions they can impose. [4] This is significant evidence that Congress did not intend to authorize FINRA to seek judicial enforcement to collect its disciplinary fines." The court also found that FINRA's authority to levy – but not collect – fines

> . . . does not support an inference of inadvertent omission because significant underenforcement of the securities laws and FINRA rules is hardly the inevitable result of FINRA's inability to bring fine-enforcement actions. FINRA fines are already enforced by a draconian sanction not involving court action. One cannot deal in securities with the public without being a member of FINRA. When a member fails to pay a fine levied by FINRA, FINRA can revoke the member's registration, resulting in exclusion from the industry. [5]

The court concluded "that the heavy weight of evidence suggests that Congress did not intend to empower FINRA to bring court proceedings to enforce its fines."

FINRA's Authority Under the 1990 Rule

In 1990 FINRA revised its rules to provide it authority to pursue the collection of fines and costs assessed in FINRA proceedings, including through external collection agencies and, in appropriate situations, through having such fines reduced to a judgment. This rule change was accomplished under Section 19(b)(1) of the Exchange Act by FINRA filing notice of the rule change with the SEC. While FINRA argued to the court that this rule change constituted authority for judicial enforcement of its fines, the court stated that "[t]his claim is something of an exaggeration" because the rule change "appears to assume a pre-existing power and to serve only as a notice of a new policy under that power." While the court found "no such pre-existing power," it noted that it "may nevertheless assume for purposes of an analysis that the 1990 Rule Change, if properly obtained, constitutes such authorization."

The court found, however, that the 1990 rule change was not properly promulgated under the procedures established by the Exchange Act. This is because, in proposing the rule, the NASD designated it as a "house-keeping rule" -- i.e., "'one constituting a stated policy with respect to the enforcement of an existing rule.'" Unlike substantive rule changes, housekeeping rules are not required to go through a notice, public comment period, and the SEC's approval before becoming effective. Instead, they by-pass this procedure and become effective upon filing with the SEC.   In the view of the court, however, the 1990 rule change was not a housekeeping rule

> that could bypass the required notice and comment period of Section 19(b). Rather, it was a new substantive rule that affects the rights of barred and suspended members to stay out of the industry and not pay the fines imposed on them in prior disciplinary proceedings. As a result, the NASD was required to file the new substantive rule with the SEC under 15 U.S.C. § 78s (b)(1) for publication of a notice and comment period. Because the NASD improperly designated the 1990 Rule Change, it was never properly promulgated and cannot authorize FINRA to judicially enforce the collection of its disciplinary fines. [6]

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Based on the above analysis of congressional intent and FINRA's authority under the 1990 rule amendment, the court reversed the judgment entered against the Plaintiffs.

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Attachment

endnotes

[1] See John J. Fiero and Fiero Brothers, Inc. v. FINRA (2nd Cir., Oct. 5, 2011) (the "Decision"), which is attached.

[2] Decision at p. 9.

[3] Ibid.

[4] The court noted that the power granted to SRO's (sic) by Section 15A of the Exchange Act to discipline their members applies to all SRO's (sic), and not just FINRA. See Decision at no. 6.

[5] Decision at p. 13.

[6] Decision at p. 21.
