



SECOND CIRCUIT REVIEW

Expert Analysis

FINRA's Inability to Bring Court Actions to Collect Fines

This month, we discuss *Fiero v. Financial Industry Regulatory Authority Inc.*,¹ in which the U.S. Court of Appeals for the Second Circuit held that the Financial Industry Regulatory Authority Inc. (FINRA) lacks authority to bring court actions to collect disciplinary fines. The panel's unanimous decision, written by Judge Ralph K. Winter and joined by Chief Judge Dennis Jacobs and Judge John M. Walker Jr., reversed the district court's dismissal of the plaintiffs' declaratory judgment action and vacated the money judgment entered by the district court on FINRA's counterclaim.

Background

The convoluted procedural history of this case spans more than 13 years and includes an assortment of twists and turns. The case, which began as a disciplinary proceeding, wound its way through the New York state court system, eventually landing in federal court.

FINRA's Role. FINRA is a "self-regulatory organization" (SRO) registered with the Securities and Exchange Commission (SEC), pursuant to the Maloney Act of 1938. It is the successor to the National Association of Securities Dealers (NASD) and was formed in July 2007 when the NASD consolidated with the regulatory arm of the New York Stock Exchange. FINRA is the sole SRO providing member-firm regulation for securities firms that conduct business with the public in the United States.²

FINRA has the power to initiate disciplinary proceedings against any FINRA member or associated person for violating any FINRA rule, SEC regulation, or statutory provision. To issue a complaint, FINRA's Department of Enforcement or Department of Market Regulation first must obtain authorization from the Board of Directors of FINRA Regulation or the Board of Governors of FINRA. After a complaint is issued, a hearing panel will conduct a hearing and issue a decision. Final decisions may be appealed to the FINRA National Adjudicatory Council (NAC), which has the ability to affirm, modify, or reverse the hearing panel's decision. The NAC decision may



By
**Martin
Flumenbaum**



And
**Brad S.
Karp**

be appealed to the SEC and appealed from the SEC to the U.S. Courts of Appeals.

FINRA Disciplinary Proceedings. Fiero Brothers was a FINRA member and broker-dealer registered with the SEC, and John J. Fiero was the firm's sole registered representative.³ On Feb. 6, 1998, NASD's Department of Enforcement initiated disciplinary proceedings against Fiero Brothers, and on Dec. 6, 2000, an NASD hearing panel held that the firm and Fiero violated Section 10(b) of the Exchange Act, Rule 10b-5, and FINRA Conduct Rules 2110, 2120,

The case, which began as a disciplinary proceeding, wound its way through the New York state court system, eventually landing in federal court.

and 3370. In addition, the hearing panel expelled Fiero Brothers, barred Fiero from associating with any FINRA-member firm in any capacity, and fined them \$1 million plus costs, jointly and severally. Fiero Brothers and Fiero (collectively, "the Fieros") appealed; on Oct. 28, 2002, the NAC affirmed the hearing panel's decision in its entirety. The Fieros did not appeal to the SEC.

New York State Court Proceedings. The Fieros subsequently refused to pay the fine, and FINRA commenced an action on Dec. 22, 2003, in New York Supreme Court. On Sept. 12, 2005, the Supreme Court found in favor of FINRA, concluding that "NASD's claim [was] firmly based on ordinary principles of contract law" because the Fieros had "expressly agreed to comply with all NASD rules, including the imposition of fines and sanctions" by registering with NASD.⁴ On May 11, 2006, the Supreme Court, New York County, awarded the NASD a judgment in the amount of \$1.3 million.⁵

The Appellate Division, First Department, affirmed the Supreme Court's decision,⁶ but the New York Court of Appeals reversed on the ground that the state courts lacked subject matter jurisdiction, holding that the FINRA complaint constituted an action to enforce a liability or duty created under the Exchange Act, and thus fell within the exclusive jurisdiction of the federal courts.⁷

Federal Court Proceedings. On Feb. 8, 2008, the day after the New York Court of Appeals issued its ruling, the Fieros filed an action in the Southern District of New York, seeking a declaratory judgment that FINRA has no authority to collect fines through judicial proceedings. FINRA responded by filing a counterclaim, seeking to enforce the fine under a breach of contract theory. Both parties moved to dismiss, and on March 30, 2009, Judge Victor Marrero granted FINRA's motion to dismiss the Fieros' declaratory judgment action, denied the Fieros' motion to dismiss FINRA's counterclaim, and instructed the clerk to enter judgment in favor of FINRA.⁸

Second Circuit's Decision

On appeal, the Fieros argued that, though the Exchange Act and FINRA's rules authorize FINRA to impose sanctions on its members, FINRA has no authority to bring judicial actions to collect monetary sanctions. FINRA claimed it derived such authority under both the Exchange Act and a FINRA rule submitted to, and not disapproved by, the SEC in 1990 (the "1990 Rule Change").

The Second Circuit sided with the Fieros, holding that FINRA lacked such authority under either the Exchange Act or the 1990 Rule Change, reversed the district court's judgment dismissing the Fieros' declaratory judgment action, and vacated the monetary judgment entered in favor of FINRA.⁹

FINRA's Authority Under the Exchange Act. Under Section 15A(b) of the Exchange Act, SROs have the statutory authority and obligation to "appropriately discipline[]" their members "by 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."¹⁰ But, as the Second Circuit panel noted, "there is no express statutory authority for SRO's to bring judicial actions to enforce the collection of fines."¹¹

Focusing on congressional intent, the panel explained that "Congress did not intend to empower

MARTIN FLUMENBAUM and BRAD S. KARP are litigation partners at Paul, Weiss, Riffkind, Wharton & Garrison LLP, specializing in complex commercial and white-collar defense litigation. MARQUES TRACY, a litigation associate at the firm, assisted in the preparation of this column.

FINRA to bring judicial actions to enforce its fines.” First, the court noted how the statutory scheme of the Exchange Act “carefully particularizes an array of available remedies, including permissible actions in the federal courts” and also “provides express statutory authority for the SEC to seek judicial enforcement of penalties.” For example, the court pointed to Sections 21(d) and 21(e), which explicitly set forth the commission’s authority to bring actions to enjoin any person “who is engaged or is about to engage in acts or practices constituting a violation” of, or to seek “writs of mandamus, injunctions, and orders” from the federal courts commanding compliance with, any provision of the Exchange Act, the corresponding rules and regulations, the rules of a national securities exchange, or the rule of a registered securities association of which such person is a member.

The court also pointed to Section 21(f), which prohibits the SEC from bringing “any action pursuant to subsection (d) or (e)...against any person for violation of, or to command compliance with, the rules of a self-regulatory organization...unless it appears to the Commission that (1) such self-regulatory organization...is unable or unwilling to take appropriate action against such person in the public interest and for the protection of investors, or (2) such action is otherwise necessary or appropriate in the public interest or for the protection of investors.”¹²

Based on these explicit grants of authority, the Second Circuit held that Congress “was well aware of how to grant an agency access to the courts to seek judicial enforcement of specific sanctions, including monetary penalties.”¹³ Despite this awareness, however, “there are no explicit provisions in the statute authorizing SRO’s to seek judicial enforcement of the variety of sanctions they can impose.” The court found this absence of any provision constitutes “significant evidence that Congress did not intend to authorize FINRA to seek judicial enforcement to collect its disciplinary fines.”

Second, the Second Circuit pointed to various statutory provisions that affirmatively support the view that FINRA does not have the power to collect fines through judicial enforcement. In this regard, the court noted an aggrieved party’s ability to appeal FINRA’s sanctions to the SEC and then to the U.S. Courts of Appeals. Had Congress intended to permit judicial enforcement, the court suggested, “it would surely have provided for some specific relief other than leaving SRO’s to common law proceedings in state courts or in federal district courts under diversity jurisdiction.”¹⁴

Further, the court suggested that FINRA’s breach of contract theory undermines the reality that Congress granted to enforce the Exchange Act. Indeed, the court noted, “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.”¹⁵

The court was unmoved by the “seemingly inexplicable nature of a gap in the FINRA enforcement scheme: fines may be levied but not collected.” Such a gap does not necessarily support an inference of inadvertent omission, however, because “FINRA fines are already enforced by a draconian sanction not involving court action,” namely, FINRA’s ability to revoke a member’s registration for failure to pay a fine, which results in the member’s exclusion from the industry.¹⁶ Additionally, where a fine is based on a violation of the Exchange Act, as was the case

with the Fieros, the violator will inevitably face “a panoply of private and SEC remedies.”

Finally, the court noted NASD’s longstanding practice of relying exclusively on its powers to revoke registration or deny reentry into the industry as its methods of punishment. Indeed, the court suggested that the action against the Fieros was the first to seek judicial enforcement of fines, further supporting the inference that “NASD believed that it lacked judicial enforcement power.” The fact that Congress was aware of NASD’s reliance on alternative enforcement methods, and failed to alter them, supports the argument that Congress did not intend to vest FINRA with the authority it sought to exercise against the Fieros.

FINRA’s Authority Under the 1990 Rule Change. FINRA also argued that a rule filed with the SEC on April 10, 1990, grants it authority to seek judicial enforcement of the disciplinary fines it levies. The proposal provided notification that the NASD “intends to pursue other available means for the collection of fines and costs imposed... in disciplinary decisions.”¹⁷ Further, the NASD advised that should “its own internal efforts for the collection of fines and costs imposed...fail,” it may refer a matter “to external collection agencies and in appropriate situations, ...seek to reduce such fines to a judgment.”¹⁸

The court stated that FINRA’s claim that the 1990 Rule Change constitutes authority for judicial enforcement of fines “is something of an exaggeration,” because FINRA failed to promulgate

After the Second Circuit’s ruling in ‘Fiero,’ it is clear that FINRA may not seek judicial enforcement to collect disciplinary fines. It is left to be seen to what extent FINRA will exercise its authority to revoke or suspend members’ registrations, particularly in instances where the violations are outside the ambit of the Exchange Act.

the rule in compliance with the procedures set forth in Section 19(b) of the Exchange Act. Section 19(b) provides that, to change its governing rules, an SRO must file any proposed rule change with the SEC, “accompanied by a concise general statement of the basis and purpose of such proposed rule change,” then go through the notice-and-comment period and obtain SEC approval before the rule becomes effective.

Congress did set forth an exception in Section 19 to the notice-and-comment process for so-called “House-Keeping” rules, “which do not substantially affect the public interest or the protection of investors.” Such proposed rule changes take immediate effect upon filing with the SEC, particularly if the SRO designates the proposed rule as “constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule” of the SRO. In proposing the 1990 Rule Change, the NASD designated it as a “House-Keeping” rule that constituted “a stated policy with respect to the enforcement of an existing rule of the NASD under §19(b)(3)(A)(i) of the [Exchange] Act.”¹⁹

The Second Circuit, however, explained that it is “not bound by the NASD’s characterization

as to whether the 1990 Rule Change affected the substantive rights of members.”²⁰ Noting the lack of statutory authority, the longstanding practice of failing to seek judicial enforcement, and the NASD’s history of seeking the SEC’s assistance in obtaining court orders, the Second Circuit held that the 1990 Rule Change was “not simply a stated policy change,” but instead was “a new substantive rule that affected 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.”²¹ Thus, the court concluded that because the NASD failed to follow the notice-and-comment process, the proposed rule could not authorize FINRA to enforce judicially the collection of its disciplinary fines.

Conclusion

In 2010, according to FINRA’s Year in Review and Annual Financial Report, FINRA filed 1,310 disciplinary actions, barred 288 individuals, suspended 428 others, expelled 14 firms, and levied fines in the amount of \$42.2 million. After the Second Circuit’s ruling in *Fiero*, it is clear that FINRA may not seek judicial enforcement to collect disciplinary fines. Given the permitted gap between levying and enforcing fines, FINRA now appears formally limited to its more “draconian” forms of punishment, though most reputable member-firms realistically will not wish to challenge FINRA’s fine collection enforcement powers. It is left to be seen to what extent FINRA will exercise its authority to revoke or suspend members’ registrations, particularly in instances where the violations are outside the ambit of the Exchange Act.

While the Second Circuit noted, in dicta, that it “intimate[d] no opinion on the validity of a properly promulgated rule authorizing fine collection through judicial proceedings,” it would seem unlikely that the SEC would approve such a rule, given the Second Circuit’s lengthy discussion on the lack of statutory authority to do so.

1. *Fiero v. Fin. Indus. Regulatory Auth. Inc.*, ___F.3d___, 2011 WL 4582436 (2d Cir. Oct. 5, 2011).

2. Because of the long history of the case, most of the relevant facts and background occurred prior to FINRA’s formation and instead involved the NASD. However, as the Second Circuit explained, the distinction is irrelevant to the merits and disposition of the case. *Fiero*, 2011 WL 4582436, at *1 n.1.

3. *Id.* at *2.

4. *Nat’l Ass’n of Sec. Dealers Inc. v. Fiero*, 2005 N.Y. Slip Op. 30161[U], at 2, 2005 WL 6012105 (Sup. Ct. Sept. 12, 2005).

5. *Nat’l Ass’n of Sec. Dealers Inc. v. Fiero*, 2006 N.Y. Slip Op. 30302[U], 2006 WL 5251396 (Sup. Ct. New York Co. May 11, 2006).

6. *Nat’l Ass’n of Sec. Dealers Inc. v. Fiero*, 33 A.D.3d 547, 827 N.Y.S.2d 4, 5 (1st Dept. 2006).

7. *Fiero*, 882 N.E.2d at 881-82.

8. *Fiero v. Fin. Indus. Regulatory Auth. Inc.*, 606 F.Supp.2d 500 (S.D.N.Y. 2009). The Southern District did not initially specify the amount of the judgment, but ultimately entered a judgment in the amount of \$1,010,809.25, with costs and interest.

9. *Fiero*, 2011 WL 4582436, at *3-9. The Second Circuit disagreed with the district court’s conclusion that it lacked federal question jurisdiction, stating that “[o]n its face, the complaint states a claim under the Exchange Act,” and thus the court had federal question jurisdiction “to determine whether FINRA has authority to collect through judicial proceedings fines levied pursuant to the Exchange Act.” *Id.* at *3 n.5.

10. 15 U.S.C. §78o-3(b)(7).

11. *Fiero*, 2011 WL 4582436, at *3.

12. *Id.*

13. *Id.*

14. *Id.* at *5.

15. *Id.*

16. *Id.*

17. Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by National Association of Securities Dealers Inc. Relating to the Collection of Fines and Costs in Disciplinary Proceedings, Exchange Act Release No. 28227, 46 SEC Docket 1049 (July 18, 1990), 1990 WL 320480, at *1.

18. *Id.*

19. See 1990 WL 320480, at *1.

20. *Fiero*, 2011 WL 4582436, at *8.

21. *Id.*