Sutherland Study on Litigating Against the SEC and FINRA Shows It Sometimes Pays for Broker-Dealers and Registered Representatives to Take on the Regulators

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Whenever firms and individuals are faced with Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA, formerly NASD) investigations and enforcement actions, the question is raised about whether it is better to settle or litigate. For the past several years, Sutherland Asbill & Brennan LLP (Sutherland) has conducted studies analyzing this issue. This year’s study shows that it sometimes pays to litigate, rather than to settle.

Since 2005, Sutherland has conducted a study of litigated disciplinary proceedings brought by FINRA against broker-dealers (BDs), registered representatives and associated persons. Since 2008, Sutherland also has analyzed administrative proceedings brought by the SEC against those same types of respondents. This year’s study analyzes cases from October 2010 through March 2012 (the “Study Period”) where BDs and individuals were charged with violating SEC and FINRA statutes, rules and regulations. The Study Period coincides with the SEC’s 2011 fiscal year and the first half of the 2012 fiscal year.

Many BDs, registered representatives and associated persons fear litigating against regulators because the staff has often spent months or even years investigating the conduct. The SEC and FINRA are well-funded, with their own procedural rules, and the hearing officers are closely associated with the regulators. Respondents fear that “the house that the regulators built” gives the SEC and FINRA a “home field” advantage. However, the Sutherland studies have shown that it sometimes pays for BDs and individuals to litigate, rather than to settle.

Both the SEC and FINRA have jurisdiction to bring enforcement cases against BDs, registered representatives and associated persons. FINRA was created in July 2007 through the consolidation of NASD and NYSE Member Regulation. According to FINRA, it oversees approximately 4,400 brokerage firms and approximately 630,000 registered representatives.

The Results of the Study

I. Trials

SEC administrative enforcement proceedings begin with the SEC’s Division of Enforcement filing a complaint, called an Order Instituting Proceedings (OIP). The cases are tried before an SEC Administrative Law Judge (ALJ), who is independent of the Commission but who hears the cases pursuant to authority delegated by the Commission itself. After a hearing, the ALJ issues an initial decision that includes findings of fact, legal conclusions and, at times, a sanction.

1 Sutherland’s first study was titled “The House That the Regulators Built: An Analysis of Whether Respondents Should Litigate Against NASD.” It was published in BNA’s May 2005 Securities Regulation & Litigation Report, and won the 2006 Burton Award for Legal Achievement. It is available at http://www.sutherland.com/file_upload/bna.pdf.
A FINRA disciplinary proceeding begins when the Department of Enforcement or the Department of Market Regulation files a complaint, and culminates in a hearing before a Hearing Panel with two current or former industry members and one Hearing Officer, who is a FINRA employee. The Hearing Officer serves as Chair of the Hearing Panel and oversees the proceedings, making rulings about the schedule, the procedures, and what evidence will be admitted. The Hearing Officer also writes the decision of the Panel.

Complaints and OIPs include one or more “charges” alleging a violation of a rule or statute. The study found the following regarding SEC initial decisions and FINRA Hearing Panel decisions:

A. Liability

Of the 126 charges that were litigated by the SEC and FINRA and resulted in SEC initial decisions or FINRA Hearing Panel decisions during the Study Period, BDs and individuals succeeded in getting 12.7% of the charges dismissed.2

1. SEC Respondents

Only seven respondents litigated against the SEC during the Study Period, and none convinced the ALJ to dismiss any charges.

2. FINRA Respondents

These respondents succeeded in getting 14.3% of the charges dismissed,3 nearly double the success rate of respondents during Fiscal Year (FY) 2009 and FY 2010 (7.6%).4

3. Representation by Counsel in FINRA Proceedings

FINRA respondents with counsel are significantly more successful than pro se respondents. FINRA respondents represented by counsel succeeded in getting 18.8% of charges dismissed.5 FINRA respondents without counsel, on the other hand, went 0-for-27 during the period. Since January 2006, only one pro se FINRA respondent has succeeded in getting any charge dismissed.

B. Fraud Charges

During the Study Period, SEC staff successfully proved all three of the fraud charges brought. FINRA staff failed to prove more than 22% of its fraud charges.6 This is far less than its success rate for charges generally. In FY 2009-2010, FINRA staff succeeded in proving all of its fraud charges (five fraud charges against four respondents).

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4 FY 2009 refers to October 1, 2008 to September 30, 2009; FY 2010 refers to October 1, 2009 to September 30, 2010.
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C. FINRA Enforcement Priorities

Sutherland’s annual survey on FINRA sanctions identified five categories of charges in which FINRA, in 2011, had obtained the greatest aggregate amount of fines through disciplinary actions.7 Those categories were: advertising, auction rate securities, suitability, and improper form U4, U5 and Rule 3070 filings. An analysis of the litigated cases during the Study Period demonstrates that FINRA generally has had success in proving those categories of charges. FINRA staff succeeded in proving all five of its advertising charges and all nine charges relating to Forms U4 and U5. With respect to suitability, FINRA staff succeeded in proving three of five charges. However, FINRA successfully proved only one of four charges in its only case during the Study Period involving auction rate securities.

II. Sanctions

This section discusses only those cases where the decisions indicate a specific sanction sought by the staff.

A. Monetary Sanctions

When SEC and FINRA respondents were found to be liable for one or more charges, 31.3% of the time, respondents convinced the ALJ or Hearing Panel to impose lower monetary sanctions than those sought by the staff.8 Respondents in FY 2009-2010 had a similar rate of success (33%).9

1. SEC Respondents

These respondents convinced ALJs to impose lower monetary sanctions 28.6% of the time during the Study Period.10 In contrast, in FY 2009-2010, ALJs lowered monetary sanctions approximately 50% of the time.11

2. FINRA Respondents

These respondents convinced Hearing Panels to reduce the proposed monetary sanction 33.3% of the time during the Study Period.12 When fines were reduced, the proposed fine ranged from $15,000 to $30,000, and averaged $21,250. The amount ordered ranged from $5,000 to $20,000, and averaged $9,250 (a reduction of approximately 56%). FINRA respondents were more successful during the Study Period than during FY 2009-2010,13 when their success rate was 27%.

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3. **Increase by Adjudicator**

As in FY 2009-2010, SEC ALJs never ordered a higher monetary penalty. Three FINRA Hearing Panels ordered fines greater than those requested by FINRA staff. In two instances, the Hearing panel doubled the fine. During FY 2009-2010, only one Hearing Panel ordered a higher fine (doubling the requested fine).

**B. Suspensions From the Industry**

When SEC and FINRA respondents lost on liability, they convinced the adjudicators 31.6% of the time to impose a suspension less than that sought by the staff. 14

1. **SEC Respondents**

None of the seven SEC respondents succeeded in convincing the ALJ to order a sanction less than that sought by the SEC staff. In contrast, in FY 2009-2010, respondents were successful approximately 30% of the time. 15 However, during the Study Period, no ALJ imposed a higher sanction than was sought by SEC Staff.

2. **FINRA Respondents**

These respondents were more effective in reducing sanctions, succeeding approximately 50% of the time. 16 FINRA respondents were more effective recently than in FY 2009-2010, when they succeeded only 37% of the time. 17 In addition, when FINRA staff sought a suspension of a set amount of time (as opposed to a complete bar), respondents convinced the Hearing Panel to reduce the suspension 37.5% of the time. 18 The Hearing Panel increased the suspension 25% of the time. 19 When FINRA staff sought a complete bar from the industry, 75% of respondents convinced a Hearing Panel to impose a lesser sanction. 20

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III. Initial Appeals

SEC ALJ initial decisions can be appealed to the SEC Chairman and the SEC Commissioners either by the respondent or by the Division of Enforcement. Alternatively, the Commission may, on its own initiative, order a review of any initial decision. For FINRA disciplinary actions, after the Hearing Panel trials, appeals are heard by the National Adjudicatory Council (NAC), which is composed of representatives of member firms and the public. FINRA Enforcement or Market Regulation staff or the respondent may appeal; alternatively, the NAC may decide on its own to review a case. The study made the following findings regarding initial appeals:

A. SEC

Six SEC respondents appealed and one respondent cross-appealed to the Commission. Of those, two respondents (or 28.6%) were successful in getting the charges against them dismissed, including the respondent who cross-appealed from the ALJ’s initial decision. Another respondent was successful in having his sanction reduced (from a complete bar to a bar with right to reapply after two years). The Commission increased the sanctions for three respondents, including in one instance where the SEC staff cross-appealed the ALJ decision. In contrast, in FY 2009-2010, no respondents succeeded in getting the charges dismissed, 33% were successful in getting reduced sanctions, and sanctions were increased approximately 22% of the time.

B. FINRA

No FINRA respondent was successful in having all findings of violations reversed, but approximately 11% were able to get one or more findings of violations reversed. In contrast, in FY 2009-2010, 17% of respondents were successful in having all findings of violations reversed. Although only 11% of FINRA respondents were able to obtain a reversal on at least one violation during the Study Period, 29.7% of respondents succeeded in obtaining reduced sanctions. The NAC increased sanctions for 32.4% of the respondents. In the eight cases where sanctions were increased, FINRA Enforcement staff appealed in one case and the NAC called the case for review in another.

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21 Theodore W. Urban cross-appealed the decision of an ALJ which found that Urban (the general counsel of a broker-dealer during the relevant time) was a supervisor for purposes of liability under Sections 15(b)(4)(E) and 15(b)(6) of the Securities Exchange Act of 1934 despite also stating that Urban did not have the traditional powers of someone who supervised brokers. In the Matter of Theodore W. Urban, Admin. Proc. File No. 3-13655, Initial Decision Rel. No. 402 (Sept. 8, 2010), avail. at http://www.sec.gov/litigation/aljdec/2010/id402bpm.pdf. The ALJ ultimately dismissed the proceedings against him because the Division of Enforcement failed to establish that Urban’s supervision of the rogue registered representative was not reasonable. After both sides appealed, the Commission dismissed the proceedings against Urban because the Commission was evenly split as to whether the OIP’s allegations had been established. Admin Proc. File No. 3-13655; Rel. No. 34-66259 (Jan. 26, 2012), avail. at http://www.sec.gov/news/digest/2012/dig012612.htm. Furthermore, the initial decision of the ALJ was found to be of “no effect.”

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IV. Further Appeals

SEC respondents may appeal to the U.S. Court of Appeals. When FINRA respondents are unsuccessful before the NAC, they have the right to appeal to the SEC, and from there, to the U.S. Court of Appeals.

A. Appeals to the U.S. Courts of Appeals

Nine respondents (five FINRA respondents and four SEC respondents) appealed SEC decisions to U.S. Courts of Appeals. The Courts of Appeals affirmed the decision of the SEC in all cases.

B. Appeals to the SEC

Approximately 82% of respondents’ appeals of NAC decisions to the SEC were either dismissed without briefing or resulted in affirmed sanctions. One respondent out of 22 obtained a complete dismissal, one respondent was able to obtain reduced sanctions, and one respondent had his case remanded to FINRA for reconsideration of sanctions. Respondents thus had even less success than in FY 2009-2010, when approximately 70% of appeals were dismissed without briefing or resulted in affirmed sanctions.

V. The Timing of Litigation

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

A. Time for Trials

For SEC cases, the time between the filing of the OIP and the ALJ Initial Decision averaged just over 10.5 months. For FINRA matters, the time between the filing of the complaint and the rendering of the Hearing Panel decision averaged just over 14 months.

B. Time for Appeals

Appeals similarly take a substantial amount of time. With regard to FINRA cases, Hearing Panel decisions are stayed and respondents can therefore continue to work while appeals to the NAC are pending. NAC appeals took approximately 19 months to resolve. Appeals to the SEC, which stay the effectiveness of any FINRA-imposed sanction except for a bar or expulsion, took approximately 13 months. Thus, for FINRA respondents, the time between the filing of a complaint and the issuance of an

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29 The Commission set aside the findings of violations and the sanctions imposed by FINRA against American Funds Distributors, Inc. (AFD) for allegedly engaging in directed brokerage payments. In the Matter of American Funds Distributors, Inc., Admin. Proc. File No. 3-13055 (June 24, 2011), avail. http://www.sec.gov/litigation/opinions/2011/34-64747.pdf. FINRA had previously obtained more than $50 million in settlements from over 20 firms for similar practices. See finra.org (search term “directed brokerage”). Rather than settle, AFD chose to litigate. Before the Hearing Panel, FINRA staff sought a $98 million fine against AFD. The Hearing Panel imposed a $5 million fine and censured AFD, and the NAC affirmed. AFD appealed to the Commission and, more than six years after the complaint was filed, succeeded in obtaining dismissal of the action.

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SEC decision averages approximately 3 years and 10 months. Unfortunately, for SEC respondents, an appeal to the appropriate federal court of appeals does not operate as an automatic stay of the sanction imposed by the SEC. FINRA and SEC respondents who received decisions from the Court of Appeals during the Study Period waited on average 17 months from the date of the Commission’s decision.

About the Study

The study reviewed three SEC ALJ decisions issued between October 1, 2010, and March 31, 2012, involving seven respondents and 14 total charges, and four Commission decisions issued during that period with respect to seven respondents and 12 charges.

In addition, the study reviewed 43 FINRA Hearing Panel decisions issued between October 1, 2010, and March 31, 2012, involving 49 respondents and 115 total charges. The study also reviewed 25 appellate decisions by the NAC addressing the cases of 37 respondents and 15 SEC decisions addressing the appeals of 22 FINRA respondents.