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FINRA Enforcement Actions—Who's Afraid of the Big Bad Wolf?

FINRA disciplinary hearings are often a viable resolution alternative to accepting onerous settlement terms. However, successfully pursuing this option depends on understanding the unique features of a disciplinary process that plays out behind closed doors.

By Jeff Kern and Rena Andoh

If you're looking for an article on how to beat the Financial Industry Regulatory Authority, Inc. (FINRA) on its home court, this is not it. Between the unfettered ability to compel the production of investigative testimony and documents, a formalized case review process, and the liberal rules of evidence in force at its disciplinary hearings, FINRA does not often find itself on the losing end of a Hearing Panel decision. Thus, in most cases, avoiding a finding of liability is not a realistic expectation and the most a brokerage firm or financial professional facing disciplinary charges can hope for is to persuade the Hearing Panel to impose sanctions less severe than those offered by FINRA in a negotiated settlement. In this connection, for the reasons discussed below, FINRA disciplinary hearings are often a viable resolution alternative to accepting onerous settlement terms from FINRA. However, successfully pursuing this option depends on understanding the unique features of a disciplinary process that plays out behind closed doors. Accordingly, this article seeks to demystify FINRA's hearing procedures and offer insights to achieve the best possible results in this forum.

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FINRA's Enforcement Mandate

FINRA is a not a government agency and has no criminal jurisdiction. It is a private sector self-regulatory organization with a mandate under the federal securities laws to regulate the conduct of its member firms and their employees through the enforcement of its rules. FINRA's disciplinary authority extends only to its member firms and their employees and is limited to imposing suspensions, fines, disgorgement, restitution, certain remediative measures, and permanent bars from membership. Because it is a member organization and not a government agency, FINRA is not constrained by the Fifth Amendment right against self-incrimination and has the power to compel the production of evidence, including on-the-record testimony, from those subject to its jurisdiction. Respondents who refuse to produce requested evidence face a permanent bar for failure to cooperate.

FINRA enforcement actions emanate from inquires conducted by examiners and investigators into suspected violations of federal securities laws, SEC rules and regulations, and FINRA rules. Usually, at some point before the investigation concludes, an attorney from FINRA's Department of Enforcement will be assigned to assist in the investigation and then to bring the matter to a resolution, by either taking no action, or moving forward with formal disciplinary action.

FINRA's Disciplinary Process

FINRA disciplinary action can take two forms. If Enforcement and the respondent can agree on sanctions, then the case can be resolved through an

Acceptance, Waiver & Consent (AWC). The AWC is a boilerplate settlement agreement that contains an overview of the alleged misconduct, citation to the applicable rule violations, a series of waivers, and the sanctions that the parties have agreed on. Significantly, the AWC states that the Respondent neither admits nor denies the subject findings.

If, on the other hand, the parties cannot agree on a disposition, Enforcement has the authority to file a complaint with FINRA's Office of Hearing Officers (OHO). OHO is comprised of hearing officers employed by FINRA but administratively walled off from other FINRA departments. The duties of the hearing officer include supervising the administration of the case, issuing a case scheduling order, ruling on pre-hearing motions, and then presiding over the actual disciplinary hearing.

At the hearing, the hearing officer is flanked by two securities industry professionals who have volunteered and been trained to serve as hearing panelists. After the presentation of evidence, the hearing panel deliberates and decides whether or not the respondent is liable for the violations charged in the complaint. If liability is found, the panel then decides what sanctions to impose. Panel decisions do not have to be unanimous. The panel memorializes its findings in a decision, written by the hearing officer. Hearing panel decisions typically are issued two to six months after the conclusion of the hearing.

Both sides can appeal an adverse decision, either on the merits, or with respect to sanctions, or both, to FINRA's National Adjudicatory Council (NAC). The NAC can exercise *de novo* review and has the power to modify any aspect of the panel decision. It also can remand the case to the hearing panel with specific instructions for resolution. NAC decisions adverse to the respondent are reviewable by the SEC. SEC decisions, in turn, are reviewable by the federal court of appeals sitting in the jurisdiction where the enforcement action was brought.

Hearings usually take place at one of FINRA's offices. However, if a respondent is based in a location where there is no FINRA office, then the hearing will be held at a hotel or conference center. Hearings are not open to the public. The only persons allowed in the hearing room are the parties, their counsel, the hearing panel members, and the court reporter. Thus, gaining familiarity with the hearing process can be a difficult proposition.

There are no formal rules of evidence.

There are no formal rules of evidence, although hearing officers tend to draw upon the federal rules in making their evidentiary rulings. Hearsay is generally admissible. Enforcement is allowed to call the respondent on its case in chief. Once direct and cross-examination of conclude, the hearing panel members are free to ask questions. While FINRA disciplinary hearings share many features with criminal trials, FINRA has elected to employ terminology that emphasizes the civil nature of its disciplinary process. Thus, the proceedings themselves are called hearings, not trials; the accused is the respondent as opposed to the defendant; hearing panels decide liability not guilt; and they do not deliver verdicts, they issue decisions. Respondents are sanctioned, not sentenced.

As set forth above, the penalties that can be imposed in FINRA disciplinary actions include suspensions, fines, disgorgement, restitution, remediative measures, and permanent bars. The source of these penalties is FINRA's Sanctions Guidelines, which provide fine and suspension ranges for most specific rule violations and set forth considerations for the panel members to apply depending on the circumstances of the case. Among these considerations are prior disciplinary history, intent, investor harm, frequency and duration of the misconduct, whether the respondent attempted to conceal his or her wrongdoing, remediation, and acceptance of responsibility.

AWCs and FINRA Hearing Panel decisions are available through a portal on FINRA's website as well as through on-line research tools. FINRA Enforcement attorneys and the defense bar access these precedents for use in both settlement negotiations and to support their sanctions arguments at contested disciplinary hearings. It is important to note, however, that as a general rule, hearing panels do not consider precedent AWCs when making sanctions determinations in disciplinary actions.

The overwhelming majority of FINRA enforcement actions settle.

Before receiving authorization either to settle through an AWC or file a complaint with OHO, the assigned Enforcement attorney is required to undergo two levels of review. First, the case is vetted by the supervisory staff in the office that conducted the investigation. Then, the Enforcement attorney is required to obtain approval from FINRA's Office of Disciplinary Affairs. (ODA) by submitting a fairly detailed memorandum containing a summary of the investigative findings, a legal analysis, a litigation risk analysis, and proposed sanctions. This process is designed to promote programmatic consistency throughout FINRA with respect to how discipline is meted out. This consistency is crucial to set expectations in the securities industry for deterrent purposes and to eliminate outlier low settlement precedents that defense attorneys can exploit in negotiations.

Preference for Settlement

Not surprisingly, the overwhelming majority of FINRA enforcement actions settle. Historically, cases that do not settle, are mostly limited to those involving individuals whose acceptance of Enforcement's settlement terms would result in their permanent expulsion from the securities industry or termination from their jobs. While occasionally a small brokerage firm will elect to go to a hearing, these instances typically are confined to situations where FINRA was seeking to shut down the firm or the allegations against the firm were intertwined with those leveled against its principal(s). No large, brand name broker-dealer has sought hearing panel review in recent memory.

The historic aversion to hearing panel adjudication is the result of several factors, depending on the case. Some respondents believe that the FINRA disciplinary process is rigged in favor of Enforcement. Others fear hearing panels will impose sanctions more harsh than those being offered by Enforcement. Still others are daunted by the costs of mounting a forceful defense. While brokerage firms may be better positioned to handle litigation costs, often times it is cheaper to pay a fine than to pay an attorney to mount a defense. Firms also prefer to avoid antagonizing FINRA out of fear that doing so will draw more regulatory scrutiny.

When to Litigate

While all of these considerations are certainly relevant, they bear further analysis, especially in light of FINRA's increasingly tougher enforcement approach. The perception that FINRA's disciplinary forum is stacked in its favor is likely driven by Enforcement's impressive winning percentage. But that success is less a product of bias and more the result of Enforcement's ability to construct solid cases based on its unfettered ability to amass a formidable investigative record and a review process that eliminates weak cases. In addition, several studies, including those conducted by Brian Rubin, a former NASD Enforcement supervisor, have suggested that it in certain situations, hearing panels impose sanctions less severe than those sought by Enforcement. Costs, of course, are always a relevant consideration but, as set forth below, the ramifications of accepting FINRA's settlement terms, may justify their expenditure. Finally, with respect to brokerage firm respondents, there are strategies to litigate against FINRA without causing long-term damage to the firm's standing with FINRA.

As FINRA becomes more aggressive in their enforcement efforts, the rationale for involving hearing panels in the resolution process increases. Since the 2008 financial crisis, FINRA has dramatically increased the financial penalties it has extracted from member firms and their employees. In 2015, FINRA collected nearly $200 million in financial penalties, an all-time high. In addition, adverse publicity and the attendant reputation harm that can result from entering into settlements may also drive the decision to take the case to a hearing panel. Finally, entering into settlements involving certain violations may preclude future participation in unregistered securities offerings.

Strategic Insights

While these factors have altered the decisional calculus as to whether to fight or settle, running the table against FINRA in its own forum is still a long shot. Thus, the decision to litigate should be reserved for those cases where there are reasonable prospects for persuading the hearing panel to impose less severe sanctions than Enforcement is offering in settlement.

Of course, the operative premise of pursuing this option is the concession of liability. The idea is to go to the hearing panel and essentially say, "we admit we erred but we disagree with Enforcement as to what the reckoning should be." The challenge then shifts to developing a strategy in order to achieve this result. Given the absence of a jury and the civil dynamic that prevails during FINRA disciplinary hearings, aggressive, theatrical and manipulative advocacy rarely plays well in front of hearing panels. Thus, the trial strategy selected should avoid these elements and cases should be presented in a courteous and professional manner.

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It is crucial to present a plausible case theory, especially because two of the panel members are experienced securities professionals with inside knowledge of how the industry works. The case theory should encompass a complete and candid admission of wrongdoing accompanied by a sincere acceptance of responsibility and expression of remorse. Misconduct should be explained but not excused or rationalized.

Finally, the most persuasive element of the defense is evidence of mitigation and remediation, both of which are prominent among the sanctions considerations set forth above. There is no better way to demonstrate acceptance of responsibility than by presenting proof of proactive resolution with affected parties and the implementation of corrective action, such as new policies and procedures, training, adding additional personnel and disciplinary action. The stronger the evidence of these measures, the less the members of the hearing panel will be motivated to add to the pound of flesh that a firm already has extracted from itself.