

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

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Since 2005, Sutherland Asbill & Brennan LLP (Sutherland) has conducted a study of litigated disciplinary proceedings brought by the Financial Industry Regulatory Authority (FINRA, formerly NASD) against broker-dealer firms (BDs), registered representatives and associated persons. Since 2008, Sutherland has also analyzed administrative proceedings brought by the Securities and Exchange Commission (SEC) against those same types of respondents. This year's study analyzes cases from October 2008 through September 2010 where BDs and individuals were charged with violating SEC and FINRA statutes, regulations and rules. That time period coincides with the SEC's 2009 and 2010 fiscal years.<sup>1</sup>

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 an employee of the regulator serves as a judge. Respondents fear that "the house that the regulators built"<sup>2</sup> 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 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 4,500 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

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<sup>1</sup> FY 2008 refers to the period from October 1, 2007, to September 30, 2008; FY 2009 refers to the period from October 1, 2008, to September 30, 2009; and FY 2010 refers to the period from October 1, 2009, to September 30, 2010.

<sup>2</sup> 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](http://www.sutherland.com/file_upload/bna.pdf).

Administrative Law Judge (ALJ), who is independent of the Commission. After a hearing, the ALJ issues an initial decision that includes findings of fact, legal conclusions and, at times, a sanction.

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 237 charges that were litigated by the SEC and FINRA and resulted in SEC initial decisions or FINRA Hearing Panel decisions during FY 2009 and FY 2010 (October 2008 through September 2010), BDs and individuals succeeded in getting approximately 13% of the charges dismissed.<sup>3</sup>

### 1. *SEC Respondents*

These respondents had a relatively high success rate during the period (approximately 28%),<sup>4</sup> which was greater than in FY 2008 (approximately 19%).

### 2. *FINRA Respondents*

These respondents succeeded in getting approximately 7.6% of the charges dismissed,<sup>5</sup> although they had slightly greater success during FY 2010 (8.6%)<sup>6</sup> compared with FY 2009 (7%).<sup>7</sup> Both years represent declines from FY 2008 when FINRA respondents succeeded in getting 15% of charges dismissed.

## B. 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 approximately 9.8% of charges dismissed.<sup>8</sup> FINRA respondents without counsel, on the other hand, went 0-for-39 during the period. Since January 2006, only one *pro se* FINRA respondent has succeeded in getting any charge dismissed.

## C. Fraud Charges

Presumably, because the regulators need to prove that the respondents acted with scienter or bad intent, fraud cases are sometimes harder to prove. SEC staff failed to prove fraud charges approximately 57%

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<sup>3</sup> 31 of 237.

<sup>4</sup> 18 of 65.

<sup>5</sup> 13 of 172.

<sup>6</sup> 5 of 58.

<sup>7</sup> 8 of 114.

<sup>8</sup> 13 of 133.

of the time in FY 2009-2010;<sup>9</sup> however, all of the fraud charges lost by the staff were in one case. Interestingly, in FY 2009-2010, FINRA staff succeeded in proving all of its fraud charges (five fraud charges against four respondents in four cases). In contrast, in FY 2008, SEC and FINRA staff failed to prove fraud approximately 28% of the time (approximately 22% for the SEC<sup>10</sup> and 33% for FINRA<sup>11</sup>).

## 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, 33% of the time the ALJ or Hearing Panel imposed lower monetary sanctions than those sought by the staff.<sup>12</sup> This is a notable change from FY 2008, when respondents succeeded in obtaining lower monetary sanctions 60% of the time.<sup>13</sup>

#### 1. *SEC Respondents*

These respondents convinced ALJs to impose lower monetary sanctions 50% of the time in FY 2009-2010.<sup>14</sup> In contrast, in FY 2008, ALJs lowered monetary sanctions approximately 83% of the time.<sup>15</sup>

#### 2. *FINRA Respondents*

These respondents convinced Hearing Panels to reduce the proposed monetary sanction approximately 27% of the time in FY 2009-2010.<sup>16</sup> When fines were reduced, the proposed fine ranged from \$10,000 to \$30,000 and averaged approximately \$17,000. The amount ordered ranged from \$0 to \$10,000 and averaged approximately \$5,000 (a reduction of approximately 71%). FINRA respondents similarly had less success in obtaining reduced monetary sanctions than in FY 2008, when they succeeded 50% of the time.<sup>17</sup>

#### 3. *Increase by Adjudicator*

It was rare that the ALJ or Hearing Panel ordered higher monetary sanctions. During the two-year period, SEC ALJs never ordered a higher monetary penalty. Only one FINRA Hearing Panel ordered a fine greater than that requested by FINRA staff, doubling the fine.

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<sup>9</sup> 8 of 14.

<sup>10</sup> 2 of 9

<sup>11</sup> 3 of 9.

<sup>12</sup> 12 of 36.

<sup>13</sup> 12 of 20.

<sup>14</sup> 5 of 10.

<sup>15</sup> 5 of 6.

<sup>16</sup> 7 of 26.

<sup>17</sup> 7 of 14.

B. Time Out from the Industry

When SEC and FINRA respondents lost on liability, they convinced the adjudicators approximately 35% of the time to impose a suspension less than that sought by the staff.<sup>18</sup>

1. *SEC Respondents*

When the SEC Enforcement staff asked for a suspension or a permanent bar from the industry, respondents succeeded in convincing the ALJ to order a sanction less than that demanded 30% of the time.<sup>19</sup> In FY 2008, respondents were successful only approximately 19% of the time.<sup>20</sup>

2. *FINRA Respondents*

These respondents were more effective in reducing sanctions, succeeding approximately 37% of the time.<sup>21</sup> However, unlike SEC respondents, FINRA respondents were less effective than in FY 2008, when they succeeded approximately 55% of the time.<sup>22</sup> 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 it 50% of the time.<sup>23</sup> The Hearing Panel increased the suspension approximately 23% of the time.<sup>24</sup> When FINRA staff sought a complete bar from the industry, approximately 19% of respondents convinced a Hearing Panel to impose a lesser sanction.<sup>25</sup>

III. Initial Appeals

SEC ALJ initial decisions can be appealed to the Commission 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. Appeals are heard by the SEC Chairman and the SEC Commissioners. 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

Thirty-three percent of SEC respondents were successful in getting reduced sanctions;<sup>26</sup> sanctions were increased approximately 22% of the time.<sup>27</sup> In contrast, in FY 2008, SEC respondents were successful

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<sup>18</sup> 17 of 48.

<sup>19</sup> 3 of 10.

<sup>20</sup> 3 of 16.

<sup>21</sup> 14 of 38.

<sup>22</sup> 12 of 22.

<sup>23</sup> 11 of 22.

<sup>24</sup> 5 of 22.

<sup>25</sup> 3 of 16.

<sup>26</sup> 3 of 9.

<sup>27</sup> 2 of 9.

approximately 43% of the time in having their sanctions reduced.<sup>28</sup> The SEC remanded one respondent's case back to the ALJ, who then imposed the original penalties.

B. FINRA

FINRA respondents succeeded in obtaining reduced sanctions 25% of the time,<sup>29</sup> and 17% of respondents were successful in having all findings of violations reversed.<sup>30</sup> However, like in SEC appeals, the NAC also increased sanctions for approximately 22% of the respondents.<sup>31</sup> FINRA respondents also had less success than in FY 2008, when sanctions were reduced approximately 30% of the time,<sup>32</sup> and sanctions were increased only approximately 7% of the time.<sup>33</sup>

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. SEC

Five respondents in three cases appealed SEC decisions to U.S. courts of appeals. Two appellate courts affirmed the SEC and one court remanded for reconsideration of one of two findings of violations by two respondents. At the remand, the SEC dismissed charges supporting the imposition of cease and desist orders against the two respondents without considering the merits, given that the respondents were ordered to pay nearly \$4 million in disgorgement.

B. FINRA

Seventy percent of respondents' appeals of NAC decisions to the SEC were either dismissed without briefing or resulted in affirmed sanctions.<sup>34</sup> However, 20% of respondents were able to obtain reduced sanctions,<sup>35</sup> and 10% of respondents obtained complete dismissals.<sup>36</sup> Respondents thus had greater success in FY 2009-2010 than in FY 2008, when approximately 74% of appeals were dismissed without briefing or resulted in affirmed sanctions.<sup>37</sup>

Only one FINRA disciplinary appeal was decided by an appellate court, which remanded for reconsideration the restitution remedy imposed, but affirmed all other findings. Upon remand, the SEC set aside the six-figure restitution order.

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<sup>28</sup> 3 of 7.

<sup>29</sup> 9 of 36.

<sup>30</sup> 6 of 36.

<sup>31</sup> 8 of 36.

<sup>32</sup> 8 of 27.

<sup>33</sup> 2 of 27.

<sup>34</sup> 14 of 20.

<sup>35</sup> 4 of 20.

<sup>36</sup> 2 of 20.

<sup>37</sup> 14 of 19.

During the two-year period, the SEC considered three FINRA cases on remand from the federal courts, but affirmed all previous findings of violations and imposition of sanctions.

#### V. The “Settlement Discount” in FINRA Proceedings

“Settlement discount” is a phrase often used to convince a BD or an individual to settle, rather than litigate. After FINRA investigations, if the staff has determined to recommend that charges be brought against a respondent, the staff normally offers to settle prior to filing a complaint and litigating. According to conventional wisdom, the sanctions proposed as part of a settlement are less severe than the sanction that would be sought and presumably imposed at the hearing. In theory, this provides an incentive to settle rather than litigate.<sup>38</sup>

Sutherland surveyed counsel representing respondents in 28 proceedings decided by Hearing Panels between October 2008 and September 2010 to determine whether there is, in fact, a settlement discount. Responses were received by nine counsel, who defended ten respondents against 17 charges brought by FINRA. While the sample may not be representative, the results are interesting. Of those who responded, approximately 44% stated that the staff sought more severe penalties at the hearing than that offered in pre-hearing settlement negotiations. Although this could be interpreted as suggesting that the staff viewed the settlement offer as fair and did not want to propose a sanction that could not be defended to the Hearing Panel, it does not suggest that a “discount” for settling early is a certainty.

Hearing Panels ordered sanctions greater than those sought by the staff during settlement negotiations in only approximately 33% of cases. In several cases, respondents succeeded in obtaining significantly lesser penalties than the settlement offered by the staff. For example, one respondent was ordered to pay a fine less than 10% of the final six-figure settlement offer, and another respondent was ordered to pay a fine that was less than 18% of the settlement offer. While these figures could be statistical anomalies, they nevertheless serve as evidence that a settlement discount may not exist because the staff’s proposed settlement terms may be too harsh.

#### VI. 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 11 months, not including one case that involved parallel criminal actions and took more than four years. For FINRA matters, the time between the filing of the complaint and the rendering of the Hearing Panel decision averaged just less than 13 months.

##### B. Time for Appeals

Appeals similarly take a substantial amount of time. 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. However, with regard to FINRA cases, Hearing Panel decisions are stayed and respondents

<sup>38</sup> See *Department of Market Regulation v. Joseph A. Geraci, II*, Complaint No. CMS020143 (NAC, Dec. 9, 2004) (“[i]n settled cases, the parties forgo the cost of litigation and often agree to lesser sanctions; this is well recognized as a ‘settlement discount’”).

can therefore continue to work while appeals to the NAC are pending. NAC appeals took approximately 17 months to resolve. Appeals to the SEC, which stay the effectiveness of any FINRA-imposed sanction except for a bar or expulsion, took approximately 11 months. Thus, for FINRA respondents, the time between the filing of a complaint and the issuance of an SEC decision averages approximately three years and five months.

## About the Study

The study reviewed seven SEC ALJ decisions issued between October 1, 2008, and September 30, 2010, involving 21 respondents and 65 total charges, and seven Commission decisions issued during that period with respect to nine respondents.

In addition, the study reviewed 57 FINRA Hearing Panel decisions issued between October 1, 2008, and September 30, 2010, involving 77 respondents and 172 total charges. The study also reviewed 29 appellate decisions by the NAC addressing the cases of 36 respondents, and 14 SEC decisions addressing the appeals of 20 FINRA respondents.



*If you have any questions regarding this article, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.*

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