

Client Alert

LITIGATION DEPARTMENT | OCTOBER 2011

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FINRA Cannot Bring Lawsuits to Collect Disciplinary Fines

On October 5, 2011, the U.S. Court of Appeals for the Second Circuit ruled that the Financial Industry Regulatory Authority ("FINRA") does not have the authority to bring court actions to collect disciplinary fines. *Fiero v. Fin. Indus. Regulatory Auth., Inc.*, Docket Nos. 09-1556-cv, 09-1863-cv, 2011 U.S. App. LEXIS 20173 (2d. Cir. 2011). The ruling comes after a 14-year legal battle between FINRA (and its predecessor, NASD) and Fiero Brothers, Inc., a New York broker-dealer, and its owner, John J. Fiero (collectively, the "Fieros").

The dispute between FINRA and the Fieros stems from a 1998 disciplinary action in which the Fieros were found to have violated NASD short-selling restrictions, ultimately resulting in the expulsion of the broker-dealer, an industry bar for John Fiero, and the assessment of a \$1 million fine. When the Fieros refused to pay the fine, FINRA filed suit in a New York state court to collect the fine plus costs. The state court ruled in favor of FINRA and awarded a \$1.3 million judgment, but the decision was ultimately overturned by the New York Court of Appeals based on a finding that a state court lacked subject matter jurisdiction over the case.

Immediately following this ruling, the Fieros filed suit in federal district court seeking a declaratory judgment that FINRA did not have authority to collect fines through judicial proceedings. The district court dismissed the complaint, holding that the Securities Exchange Act of 1934 ("Exchange Act") did not limit FINRA's ability to bring judicial actions to enforce fines.

On appeal, however, the Second Circuit disagreed, holding that the Exchange Act does not provide express authority for FINRA (or any self-regulatory organization ["SRO"]) to bring a court action to collect a fine. The Court also cited provisions of the Exchange Act that grant the SEC explicit authority to file suit to collect fines, and concluded that Congress decided not to do so for FINRA.

The Second Circuit also rejected FINRA's claim that an NASD rule passed in 1990 (the "1990 Rule Change") gave the SRO authority to collect fines through judicial proceedings. Under Section 19(b) of the Exchange Act, substantive rule changes require, *inter alia*, a notice and comment period and SEC approval. Instead of using these procedures to promulgate the 1990 Rule Change, FINRA chose to use the "housekeeping" exception under Section 19(b)(3) of the Exchange Act, which authorizes SROs to pass certain administrative and interpretive rules that can be deemed effective immediately. The Second Circuit rejected this argument, holding that the 1990 Rule Change was "a new substantive change 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 proceedings."

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CONCLUSION

As a practical matter, FINRA rarely seeks to collect fines from broker-dealers or individuals that have been barred from the industry. Nonetheless, FINRA's ability to collect such fines through judicial proceedings had never before been put to the test. As a result of this decision, FINRA will need new legislation from Congress – or attempt to properly promulgate a new FINRA rule – in order to enforce fines through judicial proceedings in the future. More importantly, however, this ruling calls FINRA's rule-making procedures into question. Specifically, any other substantive rule passed through the housekeeping exception may now be invalid. Accordingly, FINRA members and their legal counsel defending against FINRA disciplinary actions should be aware of the administrative steps taken by FINRA in promulgating any rules relevant to such action.

If you have any questions about this Client Alert, please contact:

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