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Ten Tips for Winning a FINRA Disciplinary Case against Executives and Supervisors

By Peter Boutin

FINRA's Departments of Enforcement and Market Regulation take great pride in their win records trying disciplinary cases before a FINRA Hearing Panel. Indeed, at the 2015 SIFMA Compliance and Legal Conference, FINRA Enforcement Head J. Bradley Bennett proudly announced that the Enforcement Department had prevailed in all 27 cases that were tried at a Hearing Panel in 2014.[1] This stunning record makes the SEC's incredible trial record before Administrative Law Judges pale in comparison.[2]

That said, our firm's recent trial win against FINRA's Department of Market Regulation in a case involving a Managing Director confirms that executives and supervisors should not simply capitulate to FINRA's proposed –– often excessive –– settlement demands. Set forth below are ten "lessons learned" during the course of that case and other disciplinary cases against executives and supervisors which we have tried.

1. Know FINRA's Rules *and* Practices

The first step in defending a FINRA disciplinary complaint is to familiarize yourself with FINRA's Guide to the Disciplinary Hearing Process ("the Guide"). The Guide describes Pre-Hearing Procedures for, among other things, the Initial Pre-Hearing Conference, general motions, Motions for Summary Disposition, Discovery of Documents, Production of the Department of Enforcement's file and Requests for Information. However, the Guide noticeably neglects to provide notice that –– as happened in the recent FINRA case we handled –– the Hearing Officer may exclude an expert witness who ordinarily would be allowed to testify in federal or state courts. The Hearing Officer held that the Panel would not allow an expert witness to testify because "expert testimony in FINRA proceedings is limited to 'novel issues or new, complex or unusual securities products', none of which exist in this case." It is crucial to know not only the written rules, but also the unwritten practices to adequately defend clients in a FINRA disciplinary hearing.

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2. Emphasize that FINRA has the Burden of Proof

Notwithstanding the substantial odds against winning a FINRA Disciplinary Hearing, always keep in mind that FINRA has the burden of proof. Reminding the Panel "early and often" that FINRA has the burden of proving each and every element of the charge is critical. In the recent FINRA case, the Panel seized on the burden argument, concluding that Market Regulation "did not prove by a preponderance of the evidence" that our client had engaged in actionable conduct.

3. While the Facts are of Paramount Importance, Don't Forget to Argue the Law

Our recently concluded FINRA case vividly demonstrates the importance of arguing both the facts *and* the law in defending a disciplinary complaint. Market Regulation alleged that our client violated MSRB Rule G-17 because he signed and initialed certain reports purportedly creating the misimpression that a member firm had conducted a supervisory review of the reports. We argued that our client properly signed off on the reports. Citing applicable legal authority, we also argued that the MSRB claim had to be dismissed as a matter of law because, among other reasons, FINRA's novel interpretation of Rule G-17 was made without prior notice to registered persons like our client. The Hearing Panel agreed that the executive did not have "reasonable notice of the applicability of the rule (Rule G-17) to the conduct at issue here," and dismissed the Rule G-17 charge.

4. Stress that the Applicable Standard is Reasonable Supervision, Not Perfect Supervision

If a supervisor is the subject of a failure to supervise charge, one can't emphasize too strongly that a supervisor must only act "reasonably," not "perfectly." In a New York Stock Exchange disciplinary case we defended on behalf of an institutional sales executive, we argued that the required level of supervision espoused by Enforcement was far beyond any semblance of "reasonable supervision." In dismissing all charges against the executive, the Panel held that "the standard is not perfection but reasonableness."

5. Roll up Your Sleeves and Leave No Stone Unturned

Thomas Edison quipped that "success is 10% inspiration and 90% perspiration." Edison's adage certainly applies to the preparation and trial of disciplinary cases. By way of example, in a disciplinary case we tried a number of years ago on behalf of a Branch Manager, the case initially appeared to be quite challenging because the member firm had previously paid substantial settlements to two customers whose accounts were handled by the same advisor. Thereafter, disciplinary charges were filed against the firm, the Branch Manager and the customers' advisor relating to the activity that gave rise to the settlements. Shortly after we were retained to represent the Branch Manager, we conducted an in-depth investigation on the two customers. Much to our client's delight, we learned that (1) Customer No. 1 had been involved in six different legal disputes with securities firms; and (2) a U.S. District Judge had issued an Order in which Customer No. 1 was found to be "a sophisticated and aggressive trader in securities." As to Customer No. 2, we discovered a pattern of shortcomings in certain of his commercial dealings, and the Panel found he was not "the type who would turn his account over to another to handle." Equipped with this evidence, the Panel found neither customer credible, and determined that they were "willing players in the handling of their accounts." Following a hotly contested hearing, the failure to supervise charge against the Branch Manager was dismissed.

6. Credibility is Critically Important

Many disciplinary cases turn on whether the Panel finds the individual respondent to be credible. Offering documentary and testimonial evidence that supports the executive's testimony is crucial. In the recent FINRA case, we offered what we thought was compelling documentary evidence corroborating the testimony of our Managing Director client. The Panel agreed, noting that the executive provided "an honest recitation of the supervision that he regularly conducted" and his "testimony on all relevant points to be credible."

7. Make Sure the Panel Understands and Applies the Appropriate Standard

Emphasizing the relevant standard of care is critically important to obtaining a favorable decision on behalf of an executive or supervisor in a disciplinary case. In a NYSE disciplinary case against an executive, we stressed throughout the hearing that our client supervised *institutional* sales, and that his obligations differed from that of a *retail* supervisor. The Panel agreed with this important distinction. In dismissing the disciplinary complaint, the Panel noted that the executive "supervised an institutional sales operation not a retail branch officer operation. [The respondent] cannot be measured by the standards for a retail branch office manager. Both his staff and his customers are different and so must be their supervision. It must be reasonable and appropriate for the particular unit supervised."

8. Emphasize the Supervisor's or Executive's Efforts to Comply with FINRA Rules and Firm Policies

The Panel will always be interested in whether the supervisor followed the firm's supervisory procedures. In a disciplinary case in which we represented a Branch Manager who was accused of failing to supervise the stock and options trading of a widow, the Panel was extremely focused on whether the Manager had complied with the firm's supervisory policies mandating such things as the Manager's review of activity runs, written correspondence with the client, personal contact with the client and discussions with the financial advisor about the handling of the account. Noting that the Manager had done all of these things and had "addressed the problem early on," the Panel dismissed all charges against him.

9. Don't Forget the Sanction Guidelines

Being familiar with FINRA's Sanctions Guidelines is critical to the successful defense of disciplinary charges against supervisors and executives. The Sanctions Guidelines contain "General Principles Applicable to All Sanctions Determinations ("Principles") and "Principal Considerations in Determining Sanctions" ("Considerations").

The "Principles" contain numerous lifelines that can be argued in most disciplinary cases, including the following:

- "Disciplinary sanctions are remedial in nature" and are "not punitive." (No. 1)
- "Adjudicators should always consider a respondent's disciplinary history in determining sanctions." (No. 2) Obviously, if an individual respondent has had no prior regulatory involvement, this principle should be emphasized.
- Adjudicators should tailor sanctions to respond to the misconduct at issue." (No. 3)

The "Considerations" contain a separate list of factors which can be relied upon when trying a disciplinary case. These include:

- "Whether the respondent voluntarily and reasonably attempted, prior to detection and intervention, to … remedy the misconduct." (No. 4) In two disciplinary cases we defended, the supervisors had fired the subordinates who engaged in inappropriate conduct long before the Enforcement lawyers brought disciplinary charges. In both cases, the Panels noted the terminations in dismissing disciplinary charges against our clients.
- "Whether the respondent demonstrated reasonable reliance on competent legal or accounting advice." (No. 7)
- "The level of sophistication of the injured or affected customer." (No. 19)

Another reason to be mindful of the Sanction Guidelines is that the typical Case Management Order in a FINRA disciplinary case requires parties to file Pre-Hearing Briefs that include "a discussion of sanctions."

10. Emphasize – if True – the Absence of Client Harm and That the Conduct at Issue Did Not Result in Monetary Gain to the Supervisor or Executive

Hearing Panels are usually interested in whether a customer lost money and whether the respondent made money from the conduct at issue. (See Consideration No. 17) Many executives and supervisors do not directly benefit from the activities of their subordinates, so this is ordinarily an important argument to advance.

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It is difficult to prevail in a FINRA disciplinary proceeding. However, utilizing these tips may improve the prospects for prevailing on behalf of a conscientious supervisor or executive. ★

(Endnotes)

1. Mr. Bennett acknowledged that the vast majority of disciplinary cases pursued by his department (approximately 1,200 to 1,300 a year) are resolved by way of settlement commonly referred to as an Acceptance, Waiver and Consent ("AWC").

2. See "SEC Wins With In-House Judges; Agency prevails against around 90% of defendants when it sends cases to its administrative law judges," The Wall Street Journal (May 6, 2015).