

The D.C. Circuit's Remand of the SEC's Order Sustaining an NASD Disciplinary Proceeding Puts Focus on the Standard for SEC Review of Sanctions Imposed by SROs

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A recent opinion by the D.C. Circuit in *PAZ Securities, Inc. v. SEC*, No. 05-1467 (D.C. Cir. July 20, 2007), has dealt yet another blow in what had been, until a mere 18 months ago, the NASD's and other SROs' virtually routine practice of barring individuals and expelling members for refusing to provide information in the course of examinations and investigations. *PAZ* involved an NASD member firm's appeal of a Securities and Exchange Commission (the Commission) order affirming the firm's expulsion and its president's bar from the industry for failing to comply with various examination requests. In overturning the Commission's order, the D.C. Circuit held that the Commission should have considered certain mitigating factors and identified the remedial—as opposed to punitive—purpose served by the NASD's sanctions.

While any clarification of the standard of review of SRO disciplinary proceedings is significant, the *PAZ* opinion also questions the routine practice of barring firms and individuals from the industry for failing to respond to SRO requests for information and testimony. That portion of the opinion, combined with four Commission opinions issued over the past 18 months involving the rights of individuals to assert their Fifth Amendment privilege during testimony before the SROs, could prompt the newly created Financial Industry Regulatory Authority¹ to rethink not only its sanctions guidelines, but also the circumstances under which it will prosecute such cases.

Background: Commission Review of SRO Disciplinary Proceedings

Pursuant to Section 19(e)(2) of the Securities Exchange Act of 1934 (the Act), the Commission is to review with “due regard for the public interest and the protection of investors” a disciplinary sanction imposed by an SRO upon a member firm or person associated with the member firm to determine whether the sanction “imposes a burden on competition not necessary or appropriate” to further the purposes of the Act or is “excessive or oppressive.” As the D.C. Circuit has previously stated, in evaluating whether a sanction is excessive or oppressive, “the Commission must do more than say, in effect, that petitioners are bad and must be punished.” *Blinder, Robinson & Co. v. SEC*, 837 F.2d 1099, 1113 (D.C. Cir. 1988). The standard will be met if the Commission gives “[s]ome explanation addressing the nature of the violation and the mitigating factors presented in the record.” *McCarthy v.*

¹ On July 30, 2007, the NASD and NYSE consolidated their regulation, arbitration, and enforcement functions and began operating as the Financial Industry Regulatory Authority or “FINRA.” With respect to the failure to timely respond to information requests, FINRA's sanctions guidelines are consistent with those of the NASD.

SEC, 406 F.3d 179, 189-90 (2d Cir. 2005). This burden increases when a sanction would end a career or effectively close a business. *See id.*

The NASD's Sanction Guidelines provide a range of sanctions for various rule violations and categories of misconduct and suggest a number of aggravating (e.g., harm to the investing public) and mitigating factors that may apply under the particular circumstances. Most matters involve a number of rule violations, and no single "standard" fits under the circumstances. By contrast, the failure to respond to information requests or to testify is often a stand-alone charge. For this conduct, the NASD's guidelines provide that an industry bar should be the "standard" sanction for an individual who has failed to respond to requests for information and testimony, while firms should be expelled from membership in "egregious" cases. In keeping with these guidelines, the SROs have routinely expelled individuals when they fail to provide information or refuse to testify.

This standard sanction has come under scrutiny in the wake of the Commission's decision setting aside the NASD's bar of Frank Quattrone. *In re Quattrone*, Securities Exchange Act Rel. No. 53,547 (Mar. 24, 2006). A NASD hearing panel granted a summary disposition against Quattrone after he had asserted the Fifth Amendment and refused to testify. Denied an evidentiary hearing, Quattrone could not show that he had the right to assert the Fifth because the NASD was a state actor. The NASD's National Adjudicatory Council (NAC) reviewed the decision and found summary disposition appropriate. The Commission set aside the NAC's findings on the grounds that Quattrone should have been allowed to provide the evidence in question.

Following *Quattrone*, a number of individuals who asserted the Fifth have asked the Commission to review their expulsions from the industry. In the underlying proceedings, the individuals were not allowed to provide evidence that the SRO was a state actor, which they argued would have mitigated the failure to testify. The Commission found in these proceedings that it could not conduct the review required by Section 19(e) of the Act. *See In re Heinze*, Securities Exchange Act Rel. No. 56,100 (July 19, 2007); *In re Turk*, Securities Exchange Act Rel. No. 55,942 (June 22, 2007); *In re Ficken*, Securities Exchange Act Rel. No. 54,699 (Nov. 3, 2006).

It is not difficult to understand why in *Quattrone*, *Heinze*, *Turk*, and *Ficken*, the possibility that the SRO exercised the government's "coercive power" and the grave consequences of a Fifth Amendment waiver should have been considered as a factor mitigating a refusal to testify. In *PAZ*, however, the petitioners did not risk waiving constitutional rights. Instead, the Commission faced the more mundane task of reviewing sanctions for failing to provide information requested during a routine examination.

The PAZ Securities Disciplinary Proceedings

Joseph Mizrachi was President of PAZ Securities, Inc., a NASD member. In 2003, the NASD began an examination of PAZ. Unable to obtain the information it needed, the NASD sent three letters seeking additional information. After petitioners did not respond, the NASD filed a complaint, which petitioners did not answer. After the NASD mailed the complaint a second time, petitioners hired an attorney, who moved for additional time to respond. Although the motion was granted, no answer was filed. On December 31, 2003, a NASD Hearing Officer entered a default decision, imposing the "standard" sanctions: for PAZ, expulsion from NASD membership; for Mizrachi, a bar from ever associating with a member firm.

The next month, the petitioners sought to vacate the decision. They claimed two mitigating factors should have been considered: Mizrachi's emotional distress at the time the NASD requested information

and, with respect to their default on the complaint, attorney negligence. The NASD Hearing Officer denied the motion on the grounds that petitioners had not shown negligence by the attorney. On appeal to the NAC, petitioners raised an additional mitigating factor—the nature of the information requested did not involve any potential monetary gain to them. The NAC affirmed the default decision.

Petitioners appealed to the Commission, which rejected all of their contentions. The Commission emphasized that the NASD had the right to the information it had sought and that member firms and associated persons “cannot second-guess NASD’s requests.” Because the NASD had imposed the standard sanctions on petitioners, the Commission held that they were neither excessive nor oppressive. Petitioners appealed, arguing that the Commission had abused its discretion by affirming sanctions that were grossly disproportionate to their conduct without considering mitigating factors and without articulating a remedial purpose for the sanctions.

The D.C. Circuit’s Opinion

The D.C. Circuit agreed with petitioners that the Commission had not addressed all of the mitigating factors. While the Commission had emphasized the NASD’s right to the requested information and the petitioner’s obligation to respond, the court explained that petitioners were not arguing that the information was unimportant. Rather, petitioners were arguing that the failure to respond was not of monetary benefit to them and did not harm the investing public and that the information did not relate to injurious conduct. Because the Commission had not considered the nature of the information requested by the NASD, it had not addressed this mitigating factor.

According to the court, this factor deserved consideration in view of Section 19(e)(2)’s requirement that the Commission conduct its review “having due regard for the public interest and the protection of investors.” The statute authorizes the Commission to order “expulsion not as a penalty but as means of protecting investors.” Therefore, if the Commission orders expulsion, “it must explain why; furthermore, as the circumstances in a case suggesting that a sanction is excessive and inappropriately punitive become more evident, the Commission must provide a detailed explanation linking the penalty imposed to those circumstances if it wishes to uphold the sanction.” Specifically, the Commission “must explain why imposing the most severe, and therefore apparently punitive sanction is, in fact, remedial, particularly in light of the mitigating factors brought to its attention.”

The court also held that the Commission had not stated a remedial purpose for the sanctions. While the Commission had stated its view that the sanctions imposed against petitioners would serve as a general deterrent, the court explained that “‘general deterrence’ is generally a rationale for punishment, not for remediation.” Because the Commission did not offer any other rationale, the sanctions could not be considered as part of a larger remedial plan. Accordingly, the Commission abused its discretion by affirming “severe sanctions . . . without first determining that those sanctions were remedial rather than punitive.”

Significance

The *PAZ* opinion makes it clear that when the Commission reviews sanctions imposed by an SRO, neither it nor the SRO can rely on the fact that the sanction fits within its published guidelines. Even a sanction soundly within the guidelines may be grossly disproportionate in light of the individual’s or firm’s violative conduct and mitigating factors. While the published sanction may support the goal of general deterrence, that rationale is punitive and standing alone will not support the sanction. Therefore,

