

D.C. Circuit Deals Shocking Blow to FINRA Enforcement

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On July 5, 2023, the D.C. Circuit Court of Appeals enjoined FINRA from expelling Alpine Securities Corp. through an expedited disciplinary proceeding following an emergency motion for an injunction pending appeal. The repercussions of the injunction are significant because it challenges the authority of FINRA to conduct enforcement proceedings under the purview of FINRA-appointed hearing officers.

Of course, FINRA has enjoyed a long history of prevailing in federal court when broker-dealers or registered persons challenge its authority or claim that it is a state actor. The refrain is largely the same: FINRA is not a government regulator; it is a self-regulatory organization (SRO), where membership is voluntary. Thus, expulsion from membership, FINRA would say, is not much different from being kicked out of a country club.

Not so fast, says Judge Walker in a concurring opinion attached to the order. In fact, Judge Walker states, “Alpine has raised a serious argument that FINRA impermissibly exercises significant executive power.” He explains that FINRA’s hearing officers are near carbon copies of administrative law judges who, the Supreme Court held in *Lucia v. SEC*, must be appointed in accordance with the appointments clause. Judge Walker queries whether it makes a difference that FINRA hearing officers are employees of a *nominally* private corporation. In discussing why it likely does not matter, he concludes that although FINRA is private, its enforcement activities are controlled by the government. Indeed, he posits that FINRA hearing officers execute government laws subject to a government plan, with little room for private control.

Judge Walker notes his interest in further briefings on the following two constitutional issues: (1) FINRA’s hearing officers are not appointed by a government body pursuant to the appointments clause; and (2) they are shielded from removal by the SEC except for cause. Ominously, Judge Walker states that while FINRA could prevail on these issues, “that seems unlikely.” He concludes that

“[t]here is a serious argument that FINRA hearing officers exercise significant executive power. And it is undisputed that they do not act under the President. That may be a constitutional problem.”

Analysis

Many have argued to no avail that FINRA is a state actor. Now, it appears that those whose arguments were summarily dismissed in the past now have a receptive audience in the D.C. Circuit. Indeed, courts’ prior reliance on FINRA’s status as a non-governmental SRO may have run its course. Judge Walker’s concurrence highlights the reality that securities brokers do not really have a choice if they want to sell securities in the United States. In reality, FINRA membership is mandatory. There is no alternative. And FINRA is not just enforcing its own rules (which are generally vetted by the SEC); it also enforces compliance with the provisions of the Securities Exchange Act — federal law.

When framed this way, FINRA’s hearing officers are essentially ALJs exercising significant executive power who must, therefore, be appointed by the executive branch.

What’s Next?

Although the granting of an emergency injunction is a serious setback for FINRA, it is not the death penalty that it sought to impose against Alpine. One judge on the panel would have denied the injunction pending appeal. The third judge, while granting the injunction, did not join in Judge Walker’s concurrence.

Now, both sides will have the chance to fully brief the issues Alpine raises. This will give FINRA an opportunity to address Judge Walker’s concerns. If Alpine prevails on the merits before this panel, FINRA will almost certainly request a hearing before the full D.C. Circuit in what is called an en banc review. If FINRA fails to succeed in convincing the court that it is fundamentally different from the SEC, this seems primed for the Supreme Court to consider.

If Alpine ultimately prevails, it could change the landscape of FINRA enforcement. Would FINRA attempt to have its hearing officers appointed by the president under the appointments clause? Would disciplinary hearings be conducted by SEC ALJs, thus depriving FINRA of the ability to adjudicate its own rules? Time will tell, but this ruling will surely create sleepless nights for many within the SRO.

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