FINRA

Conflicts-of-Interest Leading to the "Capital Punishment"[1] Sanctioning of an Investor Advocate

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1. U.S. Court of Appeals: PAZ Secs., Inc. v. SEC, 494 F.3d 1059 (D.C. Cir. 2007). "…barring an individual from associating with a [FINRA] member firm [is] the securities industry equivalent of capital punishment."

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Introduction

- The following slides discuss the Financial Industry Regulatory Authority, Inc. (FINRA), a private entity acting as a self-regulatory organization for broker-dealers, and the circumstances leading to FINRA's sanctioning of Manuel Asensio.

- The general problems with FINRA are examined, including its pervasive conflicts-of-interest, its handling of investigations and disciplinary proceedings, its appellate body, and the limited oversight function of the SEC.

- The specific problems in FINRA's decision to prosecute Mr. Asensio are also examined, including jurisdictional issues, the basis for investigation, the Hearing Panel and NAC decisions in the enforcement case, and the NAC decision in the MC-400.

Moral Hazard Creates Potential for Abuse

- Inherent conflicts of interest of broker control and open cooperation between enforcement staff and the staff that makes hearing decisions and imposes sanctions
- Unlimited jurisdiction is encouraged by the SEC without no judicial review
- No protection against improper jurisdictional claims before imposition of “capital punishment” sanction
- Rules-based rather than principles-based investigations and enforcement
- Private for-profit corporation with governmental powers without public oversight
- No obligation to adhere to due process or administrative laws
- No whistleblower protection provisions at any level
- No codification or guidelines for readmission after bar
- Inherent biases against investors advocates (Excessive valuation and lack of transparency generates greater commissions)
- SEC or judicial oversight of examinations or sanctions limited to procedural matters

Procedural Issues in FINRA's Statutory Disqualification ("SD") Program

- The Asensio case illustrates SD being focused exclusively on technical rules, without adherence to principles or to investor protection.
- The SEC has confirmed that FINRA's SD Program has no whistleblower procedures in place to ensure that SD is not improperly influenced by members.
- With the FINRA appeal body, the National Adjudicatory Council (NAC), there is open coordination between the NAC and FINRA's enforcement, general counsel and SD staff.
- The NAC is primarily composed of brokers.
- Appeal Panel directly advised in making decisions by FINRA SD staff.
- The NAC and the SEC uniformly rubber-stamp all failure-to-respond (Rule 8210) bars.
- Though the SEC is prohibited by law from allowing FINRA to impose sanctions that are "excessive or oppressive," the SEC has a policy to abide by FINRA's ruling on any sanction under Rule 8210, having never found a mitigating circumstance for an alleged 8210 failure or a sanction that was punitive and not remedial.

Procedural Issues in Issues in FINRA's Readmission (MC400) Process

- The readmission (MC400) process for barred members is conducted by the same SD staff who issue sanctions.

- When a barred individual does apply for readmission, there are no codified guidelines on whether readmission should be granted, leaving SD with the option to impose arbitrary decisions with clear animosity towards the applicant.

- Barred individuals have no option to apply for readmission individually. A FINRA-member firm must apply on behalf of the barred individual, severely limiting the chance of a barred individual to reapply.

- An SEC official has confirmed that FINRA possesses "considerable discretion" in making any determination about readmission. The SEC has no process or motivation to limit FINRA's arbitrary standards.

Systematic Problems in FINRA's Structure and Self-Regulation

- FINRA can "tax" through regulatory fee but use those fees for non-regulatory purposes such as lobbying and multi-million dollar bonuses.

- Conflicts-of-interest arise because FINRA has an incentive to protect its member brokers before protecting members of the public. It must choose between increasing its profits and fulfilling the responsibility of safeguarding investors.

- A prominent SEC official has referred to this as FINRA's inherent 'moral hazard.'

- FINRA has shown ineptitude at catching fraud. The Madoff firm was under FINRA's jurisdiction for more than two decades.

- FINRA faces no accountability to the public. It has no direct oversight from the judiciary or legislators.

- The Asensio case shows that FINRA can abuse its regulatory power and work against investor interests, by pursuing sanctions against those who speak out against fraud.

- Unlike government regulators, FINRA can use its regulatory fees to promote itself with TV and radio advertising and to lobby members of Congress.

Law Governing FINRA Sanctions

- The SEC is charged with overseeing FINRA, but leaves FINRA "considerable discretion" in sanctioning and readmission decisions.

- The U.S. Court of Appeals leaves the SEC with discretion in determining the appropriateness of sanctions: "[T]he Commission is better equipped to judge [the significance of certain violations] than this Court."[2]

- FINRA should be reasonable, and economic and respectful in accordance with the law.

- The law authorizes "expulsion not as a penalty but as a means of protecting investors… The purpose of the order is remedial, not penal." [1]

- The SEC must show specific reasons why a sanction is remedial, rather than punitive, when reviewing a FINRA sanction on appeal.

1: *Wright v. SEC*, 112 F.2d 89, 94 (2d Cr. 1940).
2: *Stoiber v. SEC*, 161 F.3d 745, 753 (D.C. Cir. 1998).

No FINRA Jurisdiction Over Specific Material Underlying Bar

- FINRA's investigators testified that they read the Asensio user agreement and consulted with their supervisor before agreeing to its terms. This testimony shows that FINRA was informed and had acknowledged that Asensio & Company, Inc. and asensio.com were not a FINRA firm.

- Later FINRA itself ruled that the asensio.com website, the subject of FINRA's supposed "sweep" investigation, was outside FINRA's jurisdiction.

- Mr. Asensio had withdrawn his personal FINRA registration and removed asensio.com from FINRA in 1999 in response to FINRA's conflicts-of-interest and its unnecessary, overreaching investigations targeted at its short-selling.

- FINRA nevertheless proceeded with an investigation and thereafter an enforcement action directed at Mr. Asensio personally.

- There is no independent adjudication of jurisdiction available to FINRA members even though FINRA's jurisdiction is limited by law.

- FINRA refused to consider the question of jurisdiction separately, and barred Mr. Asensio for not cooperating with requests for information.

The Suspicious Investigation

- Neither Mr. Asensio, nor the Asensio broker-dealer, nor any of its employees, was ever the subject of a single industry or customer complaint, an allegation of breaching fiduciary duty, or any financial irregularity in their entire careers.

- Asensio has exposed more than 38 stock frauds that cost investors over $40 billion where FINRA failed to uncover or impose sanctions.

- FINRA's investigation of the Asensio broker-dealer supposedly done as part of a "sweep" of FINRA brokers.

- The alleged "sweep" was to monitor compliance with new so called "Grubman" disclosure rules to clarify conflicts-of-interest between broker research and generating investment banking revenue.

- Asensio's specific widely-reported investigation on Grubman had recently spurred the new Grubman rule.

- Even before it withdrew from FINRA, the Asensio broker-dealer was not involved, and never had been involved, in any investment banking business. Its only business was trading and research. As such, the Asensio broker-dealer did not have the conflict-of-interest that gave rise to the new "Grubman" FINRA rule.

Unnecessary Investigation and Enforcement Action

- The reports that were the subject of FINRA's investigation concerned PolyMedica, a company under criminal investigation for Medicare fraud and obstruction of justice, whose offices were raided by 85 FBI agents.

- The PolyMedica reports did not comply with the Grubman rule on their face. FINRA did not need any further evidence.

- Despite admitting the PolyMedica report did not comply with Grubman, despite FINRA's lack of jurisdiction over Asensio & Company, Inc., and despite Mr. Asensio not being a member, Mr. Asensio responded to over 150 separate information request and appeared for questioning.

- FINRA did not dispute facts and opinions contained in the research reports that were at issue in the investigation. The FINRA staffer responsible noted in the disciplinary hearing, "…we weren't taking issue with the facts and opinions that Mr. Asensio had in the reports…. this isn't that big a deal."

- The FINRA staffer who took Mr. Asensio's testimony was bemused by Mr. Asensio's stance that FINRA had no right to make inquiries regarding the reports published on the non-member website, "because it was such a drastic action that Mr. Asensio was taking… versus the seriousness for the investigation, it was just a 2711 case…. it was just a 2711 case and it was being really blown out of proportion."

- Despite these statements, and admitted no jurisdiction, FINRA alleged Mr. Asensio failed to respond and barred him.

Hearing Panel Decision to Bar

- The Hearing Panel decision acknowledges a lack of jurisdiction: "…NASD has not asserted jurisdiction over Asensio & Co."

- Though Mr. Asensio answered many of the written requests for information related to the Polymedica reports and appeared for an on-the-record interview – all of which is acknowledged by the Hearing Panel - the decision states that "the staff was unable to obtain all the information it needed to complete its review."

- On the basis of not supplying the information deemed to be "needed" by FINRA staff, the Hearing Panel decided to give Mr. Asensio a permanent bar sanction, prohibiting him from associating with any member firm.

- The Hearing Panel therefore deemed that Mr. Asensio's actions were tantamount to a complete and total failure to respond, despite Mr. Asensio's efforts to supply information. FINRA sanction guidelines state, "If the individual did not respond in any manner, a bar should be standard."

NAC Decision to Uphold Bar

- On appeal the NAC did not find any mitigating circumstances in Mr. Asensio's case, and upheld the Hearing Panel sanction.

- The NAC ruled that failure to answer "a single question" deserved FINRA's most severe sanction.

- The information requested that was not provided related to an entity that was not in Mr. Asensio's control, and was information he did not have. Mr. Asensio provided documentation showing this during the investigation.

NAC Decision on MC400 Application

- When Mr. Asensio applied for readmission to FINRA, the NAC asserted that he posed "an unreasonable risk of harm to the market or investors." The NAC did not say what this specific risk of harm was, nor did it state how it could be remedied.

- The NAC decision contains a deliberate mischaracterization of the record, using prior technical AWCs to paint Mr. Asensio as a "recidivist."

- The NAC asserted vague and arbitrary standards, such as timing, to assess Mr. Asensio's MC400 application. The decision states that "insufficient time has elapsed for Asensio to demonstrate his willingness or ability to operate responsibly in the securities industry," but it does not state what would constitute a sufficient amount of time.

- FINRA has confirmed that there are no definite guidelines used to evaluate MC400 applications. This confirmation was only obtained through inquiries from members of Congress acting on Mr. Asensio's behalf.

Conclusion

- FINRA acted wrongfully against Mr. Asensio.
- The FINRA sanctions against Mr. Asensio were the result of FINRA's conflicts-of-interest.
- FINRA's inherent conflicts-of-interest will lead to further actions to victimize those who speak out against fraud, and further undermine the public's confidence and investor protection.
- Congressional action must be taken to limit the powers of FINRA and the self-regulatory system in order to protect investors and limit future financial crises.