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Picking Your Battles With Regulators

Jaime Levy Pessin
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NEW YORK -- To fight or not to fight -- that is the question.

When faced with regulatory charges, firms have to decide whether to suffer the slings and arrows of regulatory fortune, or take arms against them.

A recent study found that member firms fighting regulatory charges rarely won outright but, in a silver lining, they were able to curtail the staff's proposed sanctions -- including fines, suspensions, remediation and other penalties -- 55% of the time. Looking at fines alone, individuals and firms got the hearing panels to reduce regulators' proposed penalties about 70% of the time.

The study, by law firm Sutherland Asbill & Brennan, covers firms and individuals who fought National Association of Securities Dealers charges between January 2006 and June 2007. The NASD is a precursor to the Financial Industry Regulatory Authority, which now governs the brokerage industry.

The law firm's study shows the tough odds against beating charges: Firms won outright only 22% of the time. No registered representatives had their cases dismissed entirely during that period, the study found.

When firms and individuals are faced with charges from FINRA, they can either negotiate with the regulator to settle them or they can fight the charges. If they decide to fight, the matter is ultimately heard by a FINRA hearing panel that includes a FINRA hearing officer and two industry representatives.

If a firm disagrees with the hearing panel's decision, it can appeal to FINRA's National Adjudicatory Council. From there, a firm can appeal to the Securities and Exchange Commission, and then to a federal court.

It's rare for firms to fight charges against them. The study looked at the 55 hearing panel decisions over those 18 months, along with 32 council decisions and 16 SEC decisions. In 2006, 1,147 formal disciplinary actions were resolved, according to FINRA.

Firms' odds on appeals are low: The study found that about 84% of respondents who appealed to the NAC council had the sanctions against them affirmed, or reduced by a negligible amount. (Litigants representing themselves lost all appeals to the NAC between 2000 and 2006, the study's authors pointed out; in February 2007, one pro se respondent got the NAC to reduce a $15,000 fine to $10,000 and to jettison his nine-month suspension.)

Those who appealed to the SEC lost about 71% of the time, the study found.

One of the most high-profile fights against regulatory charges was launched by American Funds Distributors Inc. in 2005, when the NASD accused the firm of directed brokerage violations. In August 2006, a hearing panel determined that the American Funds had done wrong -- but not intentionally. The panel imposed a $5 million penalty, much lower than the NASD enforcement staff's suggested fines of up to $98 million.

American Funds appealed the hearing panel decision, had a NAC hearing in August 2007, and is waiting for the decision.

"We do not believe we violated any of the NASD rules," said Chuck Freadhoff, spokesman with American Funds, the sales arm of closely held Los Angeles investment firm Capital Research & Management Co. "This is a case where we did nothing wrong and don't believe we should admit" doing anything wrong.

For firms that realize there might be some truth to the charges, the calculus becomes more difficult.

"What drives the settlement is the fear of what might happen if the wrongdoing becomes an affirmative finding of fact," said Robert Herskovits, a lawyer with Gusrae, Kaplan, Bruno & Nusbaum who represents firms in regulatory matters. In that case, firms could be opening themselves not just to "pile-on" from other regulators, but to mounds of civil litigation.

The decision to settle or fight isn't just about money. Some firms place a high value on the degree of control they keep when they settle charges. In a settlement, a firm may get some say in the actual charges filed and in the wording of the findings; regulators are less likely to use fighting words when they don't have to persuade a hearing panel of their case's merits.

Often, firms care less about money and more about describing "the underlying conduct in a way the firm considers fair and accurate," said Harry Weiss, a partner at law firm Wilmer Cutler Pickering Hale and Dorr. A former associate director of enforcement at the SEC, he represents firms in SEC enforcement matters. "You might negotiate every sentence; you want to get out the pejorative," he said.

Still, said Neal Sullivan, head of the broker-dealer practice group at law firm Bingham McCutchen, when regulators name individuals in their charges and ask for high numbers to settle cases, it becomes "increasingly difficult for the internal legal folks to support settlements.

"Previously, most firms went into the enforcement process anticipating a settlement," Sullivan said. "That is less the case today."

Brian Rubin, a Sutherland Asbill & Brennan partner who conducted the study, said firms shouldn't worry too much about generating ill will because they decide to fight regulators.

"If the litigation is done properly and well, both sides are going to have respect for each other," said Rubin, who used to be the NASD's deputy chief counsel of enforcement.

FINRA spokesman Howard Schloss declined to comment, except to say that "it's not surprising that a defense attorney is advocating more litigation."

When Morgan Stanley (MS) was charged by the NASD last year with erroneously telling arbitration claim-

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ants and regulators that emails they sought were lost in the Sept. 11, 2001, terrorist attacks, the firm called the NASD's settlement demands "disproportionate and unprecedented," and proceeded to litigate.

At the time, people familiar with Morgan Stanley's position said the firm was willing to compensate some investors whose claims might have been affected had the emails been produced. They said the NASD wanted the firm to compensate upwards of 1,000 investors who filed arbitration claims between October 2001 and March 2005, even if those claims were without merit, or didn't involve email.

The stakes were too high to accept the NASD's terms.

Still, in the end, the firm decided to settle with a $12.5 million payment, announced last week. The settlement capped the amount of money arbitration claimants could recover from the firm at $9.5 million, giving certainty and closure.

The firm's current leadership wanted "to improve the relationship with regulators," said Morgan Stanley spokesman Jim Wiggins. "Part of that is not taking an antagonistic approach to everything. Where grounds can be found to settle, that's what you do."