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Commentary

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[Editor's Note: Phillip J. Troyer is a graduate of the Indiana University (Maurer) School of Law, and Chief Compliance Officer for Resources Investment Advisors, LLC ("RIA"), an SEC-registered investment advisor. Mr. Troyer was counsel for the petitioner in Troyer v. Nat'l. Futures Ass'n., 981 F.3d 612 (7th Cir. 2020). Barry Temkin is a partner at Mound Cotton Wollan & Greengrass LLP and an adjunct professor at Fordham University School of Law, where he teaches a course on broker-dealer regulation. His firm was co-counsel for the plaintiff in Cashmore v. Fin. Indus. Regul. Auth., No. 18-CV-1198S, 2020 U.S. Dist. LEXIS 209451, 2020 WL 6566302 (W.D.N.Y. Nov. 9, 2020). The views expressed in this article are the authors' alone. Any commentary or opinions do not reflect the opinions of RIA, Mound Cotton, Fordham Law School or LexisNexis® Mealey Publications™. Copyright © 2021 by Phillip J. Troyer and Barry R. Temkin. Responses are welcome.]

The overwhelming majority of financial industry disputes are adjudicated by arbitration panels administered by the Financial Industry Regulatory Authority ("FINRA") or the National Futures Association ("NFA"). As these self-regulatory organizations ("SROs") adjudicate thousands of cases annually, they have documented a rise in uncollected arbitration awards, due to the insolvency or suspension of individual registered representatives or registered broker-dealers. For example, in Chart 1, FINRA has released the following sobering statistics about uncollectible arbitration awards over a recent five-year period:

Chart 1.

Year	Cases With Damages Issued	Cases With Unpaid Awards	% Unpaid
2013	212	63	30%
2014	177	44	25%
2015	190	41	22%
2016	158	44	28%
2017	151	51	34%

A series of proposals has been floated to deal with the problem of uncollectable awards, including the possibility of mandating insurance coverage for broker-dealers. In this context, many investors and their advocates have considered how to deal with the long-standing problem of uncollectible arbitration awards

against defunct or suspended firms. Some investors' advocates have gone so far as to consider potential suits against the SROs themselves for failing to enforce their own by-laws. In some cases, these suits include weaponizing a little-known provision in the Commodity Exchange Act ("CEA"), which permits an investor to bring a lawsuit against a registered futures association that fails to enforce its own rules or by-laws.

While there is no comparable provision in the Securities Exchange Act of 1934, the CEA provides an avenue for suing a registered futures association, such as the NFA. Specifically, Section 25(b)(2) of the CEA provides:

> A registered futures association that fails to enforce any bylaw or rule that is required under section 21 of this title or in enforcing any such bylaw or rule violates this chapter or any Commission rule, regulation, or order shall be liable for actual damages sustained by a person that engaged in any transaction specified in subsection (a) of this section to the extent of such person's actual losses that resulted in such transaction and were caused by such failure to enforce or enforcement of such by law or rule.

This provision in the CEA should be contrasted with decades of precedent in the securities industry, which have rejected investor and broker claims against SROs, reasoning SROs are entitled to a presumption of immunity under the Securities Exchange Act. In short, FINRA has been accorded immunity from suits by disgruntled investors who cannot obtain relief against defunct, deadbeat brokers—even if FINRA contributed to the investors' losses by failing to enforce its own rules.

No such immunity has been granted to the NFA or other SROs operating under the CEA. However, notwithstanding the clear road map for claims against registered futures associations, such as the NFA, research has disclosed few successful assaults on the citadel of SRO immunity.

FINRA Immunity Under 1934 Act

FINRA was formed in 2007 by the merger of the New York Stock Exchange Regulation and National Association of Securities Dealers ("NASD") Regulation, the latter being an SRO created by the Maloney Act of 1938, an amendment to the Securities Exchange Act. Although it is a membership organization and not a government agency, courts have repeatedly ruled FINRA is entitled to quasi-governmental immunity. Some courts have likened SRO immunity to sovereign immunity, focusing on SROs' status as quasi-governmental regulators. Other courts have granted SROs immunity even in cases where they were not performing strictly prosecutorial or adjudicatory functions, as long as they were acting in a quasi-governmental capacity.

For example, in *Turbeville v. FINRA,* the Eleventh Circuit Court of Appeals held a former registered representative's purported state law claims against FINRA were properly dismissed because there is no private right of action against it for violation of its own rules. FINRA served Turbeville with a *Wells* notice announcing its intent to recommend an enforcement action alleging violations of federal securities regulations. Not content to fade silently into the night, Turbeville affirmatively sued FINRA in court for a hodge-podge of state law claims, including defamation, abuse of process, intentional interference with a prospective advantage, and conspiracy. The Eleventh Circuit analyzed the broker's affirmative state law claims as "fundamentally a challenge to an SRO's compliance with its internal rules while carrying out its regulatory and enforcement functions." The court concluded Congress did not intend to create a private right of action for plaintiffs seeking to sue SROs for violations of their own internal rules, reasoning that, "the internal appeals and administrative-review processes created by the Exchange Act confirm that no private right exists." The court of appeals ultimately held a registered representative must proceed through the FINRA administrative process set forth in the Securities Exchange Act, including an adjudicatory hearing before a hearing officer and appeals to the National Adjudicatory Council and Securities and Exchange Commission ("SEC"), and could not resort to a state law action to challenge FINRA's internal administrative processes. The court reasoned it would be untenable to permit multiple, inconsistent state tort laws to supersede federal securities laws, concluding,

> Although a person regulated by an SRO might find the prescribed remedies

> incapable of [fully] assuaging the reputational harm he suffered as a result of the SRO's regulatory and disciplinary conduct. . . he chose to accept those limitations on recovery by affiliating himself with an SRO-governed firm.

Similarly, the Second Circuit granted SROs immunity in *Standard Investment Chartered v. NASD*, holding,

> There is no question that an SRO and its officers are entitled to absolute immunity from private damage suits in connection with the discharge of their regulatory responsibilities. . . This immunity extends both to affirmative acts as well as to an SRO's omissions or failure to act.

According to the court, an SRO's immunity applies to five categories:

> (1) disciplinary proceedings against exchange members;
> (2) the enforcement of security rules and regulations and general regulatory oversight over exchange members;
> (3) the interpretation of the securities laws and regulations as applied to the exchange or its members;
> (4) the referral of exchange members to the SEC and other government agencies for civil enforcement or criminal prosecution under the securities laws; and
> (5) the public announcement of regulatory decisions. . .

The plaintiffs in *Standard Investment* were NASD members aggrieved by a member fee assessment arising from the SRO's 2007 merger with New York Stock Exchange Regulation. The Second Circuit dismissed the plaintiffs' claim, reasoning the by-law amendment and member assessment were intertwined with the SRO's regulatory function and, therefore, immune from private suit. The court also noted the by-law amendment had been approved by the SEC, thereby underscoring "the extent to which an SRO's bylaws are intimately intertwined with the regulatory powers delegated to SROs by the SEC. . .".

FINRA's immunity from suit was also upheld in *Cashmore v. FINRA*, which dismissed a registered representative's attempt to reopen and challenge an acceptance, waiver, and consent he had reluctantly agreed to, allegedly under pressure, six years previously. In its defense, FINRA successfully argued in federal district court it was absolutely immune from suit and the registered representative's sole legal option was exhaustion of his administrative remedies through the FINRA administrative appeal process. Since he had expressly waived his direct administrative appeals, the plaintiff's collateral claim against FINRA to reopen his settlement was unsustainable. As the court explained in *Cashmore*:

> This Court holds that FINRA enjoys absolute immunity that deprives this Court of jurisdiction over this matter . . . . [FINRA is] protected by absolute immunity when they perform their statutorily delegated adjudicatory, regulatory, and prosecutorial functions.

The court had little difficulty in determining that the discipline of associated persons was a core regulatory function entitling FINRA to absolute immunity from suit.

Futures Industry Cases

While courts have often held FINRA is immune from suit in fulfilling its regulatory function, the NFA is subject to very different regulations, which expressly permit private causes of action under some circumstances. As noted above, § 25(b)(2) of the CEA holds a registered futures association, such as the NFA, shall be liable for actual damages sustained by a person as a result of its failure to enforce any bylaw or rule required under § 21 of the CEA.

Although Congress did not enact § 25 until 1983, an aggrieved party's right to bring a private cause of action against an SRO under the CEA had long been recognized by the courts. As the U.S. Supreme Court noted in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*:

> Prior to the comprehensive amendments to the CEA enacted in 1974, the federal

> courts routinely and consistently had recognized an implied private cause of action on behalf of plaintiffs seeking to enforce and to collect damages for violation of provisions of the CEA or rules and regulations promulgated pursuant to the statute.

Until recently, research disclosed no successful claim against the NFA pursuant to § 25(b)(2). However, in 2018, a federal district court, in *Troyer v. NFA,* denied NFA's attempt to dismiss a claim brought pursuant to 7 U.S.C. § 25(b)(2) by an investor who contended that he was defrauded by an unscrupulous former NFA Associate Member, Thomas Heneghan ("Heneghan").

Heneghan had previously been associated with Statewide FX, Inc. ("Statewide"), an introducing broker and NFA Member firm. In December of 2010, unbeknownst to the investor, the NFA issued a complaint charging Statewide, and several of its principals, with making deceptive and misleading sales solicitations. However, the investor noted the NFA's disciplinary complaint actually alleged other Associated Persons of Statewide, including Heneghan, had participated in the firm's illegal conduct. Therefore, the plaintiff contended the NFA violated NFA Bylaw 301(a)(ii)(D) by allowing Heneghan to remain an NFA Associate Member after expelling Statewide from its membership, which ultimately allowed Heneghan to defraud him as a member of a different NFA Member firm. That bylaw, which was required by § 21 of the CEA, provided: "[N]o person shall be eligible to become or remain a Member or associated with a Member who[,] . . . [w]hether before or after becoming a Member or associated with a Member, was, by the person's conduct while associated with a Member, a cause of any suspension, expulsion or order."

However, the district court subsequently granted a motion for summary judgment filed by the NFA. Specifically, the court adopted NFA's contention it had not expelled Statewide but had, instead, allowed the firm to withdraw and never reapply for membership. Therefore, the court agreed NFA was prohibited from conflating a member's voluntary withdrawal with an expulsion pursuant to a prior adjudication from the Commodity Futures Trading Commission ("CFTC").

On appeal, the investor argued the district court had exalted form over substance, given there was no meaningful difference between a firm being expelled from NFA membership and agreeing to a permanent ban under regulatory pressure—a conclusion the investor argued the CFTC had noted in a later interpretative guidance. However, the Court of Appeals disagreed. In affirming the district court's grant of summary judgment, the Seventh Circuit articulated the three elements a plaintiff must prove to bring a successful case against the NFA under the CEA:

> First, the NFA must have "fail[ed] to enforce [a] bylaw or rule that is required under section 21 of [the CEA]." . . . Second, the NFA must have "acted in bad faith in failing to take action or in taking such action as was taken." . . . Third, the NFA's "failure or action [must have] caused the loss."

With regard to the first element, the Seventh Circuit held an "'agreement not to reapply' is not an 'expulsion.'" Therefore, the court found NFA did not fail to enforce its Bylaw 301, as it was not triggered by Statewide's permanent bar from NFA membership. Thus, while recognizing parties' rights to bring a cause of action against NFA under § 25(b)(2), the Seventh Circuit appeared to grant the SRO wide latitude in determining whether it had actually violated its own bylaws.

Conclusion

Inasmuch as FINRA is an SRO subject to SEC regulation and scrutiny, the courts have consistently held it may not be sued by private sector claimants. By contrast, under the CEA, Congress specifically permits private causes of action to be brought against registered futures associations, of which the NFA is the only such entity approved by the CFTC.

However, while the CEA authorizes such lawsuits, it does not appear any such claim has ever been successfully prosecuted against the NFA. As such, it will be interesting to see if subsequent claimants attempt to bring claims that meet the criteria articulated in the Seventh Circuit's decision in *Troyer*.

Endnotes

1. NASAA Broker-Dealer Section E&O Insurance Survey Report, North American Securities Administrators Association, (Dec. 2019), https://www.nasaa.org/53339/broker-dealer-eo-insurance-could-provide-relief-for-investors-with-unpaid-arbitration-awards/.

2. Alan Wolper, F*INRA Proposes To Require Disclosure Of Insurance Information In Arbitrations. Seriously.*, Ulmer Attorneys: Broker-Dealer Law Corner (July 26, 2018) https://www.bdlawcorner.com/2018/07/finra-proposes-to-require-disclosure-of-insurance-information-in-arbitrations-seriously/; NASAA Broker-Dealer Section E&O Insurance Survey Report, North American Securities Administrators Association, (Dec. 2019), https://www.nasaa.org/53339/broker-dealer-eo-insurance-could-provide-relief-for-investors-with-unpaid-arbitration-awards/.

3. Commodity Exchange Act, 7 U.S.C. § 21(b)(2).

4. The NFA's status as a registered futures association was granted by the Commodity Futures Trading Commission in 1981. *About NFA,* NFAFutures.org, https://www.nfa.futures.org/about/index.html#:~:text=NFA%20is%20the%20industrywide%2C%20self,Members%20meet%20their%20regulatory%20responsibilities (last visited Mar. 12, 2021).

5. *See* Thomas Lee Hazen, Securities Regulation, Cases and Materials 20 (10th Ed. 2020).

6. *Turbeville v. Fin. Indus. Regul. Auth.*, 874 F.3d 1268 (11th Cir. 2017).

7. 874 F.3d at 1275.

8. 874 F.3d at 1276.

9. Valerie Sanders, *A Private Plaintiff Cannot Sue FINRA for a Violation of Its Own Rules*, 11thCircuitBusinessBlog.com (Nov. 3, 2017), https://www.11thcircuitbusinessblog.com/2017/11/a-private-plaintiff-cannot-sue-finra-for-a-violation-of-its-own-rules/ (quoting *Turbeville*, 874 F.3d at 1276).

10. *Standard Inv. Chartered v. Nat'l Ass'n of Sec. Dealers, Inc.*, 637 F.3d 112 (2d. Cir. 2011).

11. 637 F.3d at 116 (internal citations omitted).

12. *Id.* at 116.

13. *Cashmore v. Fin. Indus. Regul. Auth.*, No. 18-CV-1198S, 2020 U.S. Dist. LEXIS 209451, 2020 WL 6566302 (W.D.N.Y. Nov. 9, 2020) (wherein co-author Barry Temkin was co-counsel to plaintiff).

14. 2020 U.S. Dist. LEXIS 209451, 2020 WL 6566302, at *4–*5.

15. 456 U.S. 353, 379 (1982).

16. See *Troyer v. Nat'l. Futures Ass'n.*, 290 F.Supp.3d 874, 885 (N.D. Ind. 2018), aff'd, 981 F.3d 612 (7th Cir. 2020) (wherein co-author Phillip J. Troyer was counsel to petitioner).

17. *Id.* at 877.

18. *Id.* at 878.

19. *Id.* at 882.

20. *Id.*

21. *Troyer v. Nat'l. Futures Ass'n.*, 981 F.3d 612, 613 (7th Cir. 2020).

22. *Peterson v. Nat'l. Futures Ass'n.*, CFTC No. CRAA-91-1, 1992 CFTC LEXIS 416, 1992 WL 289773 (October 7, 1992).

23. Amendment to Interpretative Statement Regarding Statutory Disqualification from Registration, 61 Fed. Reg. 58627-01 (Nov. 18, 1996) (codified at 17 C.F.R. pt. 3, app. A).

24. *Troyer v. Nat'l. Futures Ass'n.*, 981 F.3d at 615 (internal citations omitted).

25. *Id.* at 618. ■

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