

1 UNITED STATES COURT OF APPEALS

2 FOR THE SECOND CIRCUIT

3 August Term, 2009

4 (Argued: April 6, 2010 Decided: October 5, 2011)

5 Docket Nos. 09-1556-cv(L), 09-1863-cv(XAP)

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7 JOHN J. FIERO and FIERO BROTHERS, INC.,

8
9 Plaintiffs-Counter-Defendants-Appellants-Cross-
10 Appellees,

11
12 v.

13
14 FINANCIAL INDUSTRY REGULATORY AUTHORITY, INC.,

15
16 Defendant-Counterclaimant-Appellee-Cross-
17 Appellant.

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19 -----
20
21 B e f o r e: JACOBS, Chief Judge, WINTER, and WALKER, Circuit
22 Judges.

23 Appeal from orders of the United States District Court for
24 the Southern District of New York (Victor Marrero, Judge)
25 dismissing a complaint seeking a declaratory judgment, and
26 entering a money judgment on a counterclaim. The principal issue
27 is whether the Financial Industry Regulatory Authority, Inc. has
28 the authority to bring court actions to collect disciplinary
29 fines. We hold that it does not and reverse.

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2 Bruno & Nusbaum, PLLC, New York,
3 N.Y., for Plaintiffs-Counter-
4 Defendants-Appellants-Cross-
5 Appellees.

6
7 TERRI L. REICHER, Financial
8 Industry Regulatory Authority,
9 Inc., Washington, D.C., for
10 Defendant-Counterclaimant-Appellee-
11 Cross-Appellant.
12

13 WINTER, Circuit Judge:

14 John J. Fiero ("Fiero") and Fiero Brothers, Inc. ("Fiero
15 Brothers") (together, "Fieros") appeal from Judge Marrero's
16 dismissal of their complaint, which sought a declaratory judgment
17 that, inter alia, the Financial Industry Regulatory Authority,
18 Inc. ("FINRA") lacks the authority to bring court actions to
19 collect disciplinary fines it has imposed. We hold that FINRA
20 lacks such authority. We therefore reverse the dismissal of the
21 complaint and vacate the money judgment on FINRA's counterclaim.
22

23 BACKGROUND

24 a) FINRA's Role

25 FINRA is a "self-regulatory organization" ("SRO") as a
26 national securities association registered with the SEC pursuant
27 to the Maloney Act of 1938, 15 U.S.C. § 78o-3, et seq. See
28 Desiderio v. Nat'l Ass'n of Sec. Dealers, Inc., 191 F.3d 198, 201
29 (2d Cir. 1999). FINRA is the successor to the National
30 Association of Securities Dealers ("NASD").¹ It "is responsible

¹ FINRA is a non-profit Delaware corporation that was formed in July 2007, when the National Association of Securities Dealers, Inc. ("NASD") consolidated with the regulatory arm of the New York Stock Exchange. See

1 for conducting investigations and commencing disciplinary
2 proceedings against [FINRA] member firms and their associated
3 member representatives relating to compliance with the federal
4 securities laws and regulations." D.L. Cromwell Invs., Inc. v.
5 NASD Regulation, Inc., 279 F.3d 155, 157 (2d Cir. 2002) (quoting
6 Datek Sec. Corp. v. Nat'l Ass'n of Sec. Dealers, Inc., 875 F.
7 Supp. 230, 232 (S.D.N.Y. 1995) (internal quotation marks
8 omitted)). As a practical matter, all securities firms dealing
9 with the public must be members of FINRA. See Sacks v. SEC, 648
10 F.3d 945, 948 (9th Cir. 2011) (citing 72 Fed. Reg. 42,169, 42,170
11 (Aug. 1, 2007); 15 U.S.C. §§ 78c(a)26, 78s(b)) (noting that FINRA
12 is "responsible for regulatory oversight of all securities firms
13 that do business with the public"); see also note 1, supra.
14 FINRA's disciplinary proceedings are governed by the FINRA Code
15 of Procedure ("FINRA COP").² The FINRA COP has been approved by
16 the SEC, as required by Section 19 of the Securities Exchange Act
17 of 1934. 15 U.S.C. § 78s(b) (describing the required procedure
18 for approval of proposed SRO rule changes).

19 FINRA has the power to initiate a disciplinary proceeding

Standard Inv. Chartered, Inc. v. Nat'l Ass'n of Sec. Dealers, Inc., 637 F.3d 112, 114 (2d Cir. 2011). As a result of this consolidation, FINRA is the sole SRO providing member firm regulation for securities firms that conduct business with the public in the United States. Fin. Indus. Regulatory Auth., Inc. v. Fiero, 882 N.E.2d 879, 880 n.* (N.Y. 2008). Much of the facts and background in this case occurred prior to July 2007, so we will refer to the appellee as the NASD where appropriate. The distinction is, however, irrelevant to the merits and our disposition of the case.

² The entire FINRA COP is contained in the FINRA Manual available at <http://finra.complinet.com>.

1 against any FINRA member or associated person for violating any
2 FINRA rule, SEC regulation, or statutory provision. Id. §
3 78s(h)(3). To issue a complaint, FINRA's Department of
4 Enforcement or Department of Market Regulation must obtain
5 authorization from the FINRA Regulation Board or FINRA Board.
6 FINRA COP § 9211. After a complaint is filed, a hearing panel
7 conducts a hearing and issues a decision. Id. § 9231. Final
8 decisions of the hearing panel may be appealed to the FINRA
9 National Adjudicatory Council ("NAC"), which can affirm, modify,
10 or reverse the hearing panel's decision. Id. §§ 9311, 9349(a),
11 9268-9269. NAC decisions may then be appealed to the SEC,
12 pursuant to 15 U.S.C. § 78s(d), and from the SEC to the United
13 States Court of Appeals, pursuant to 15 U.S.C. § 78y. 15 U.S.C.
14 §§ 78s(d), 78y(a); see also Mister Discount Stockbrokers v. SEC,
15 768 F.2d 875, 876 (7th Cir. 1985).

16 b) The Disciplinary Action Against the Fieros

17
18 Fiero Brothers, a New York corporation, was a FINRA member
19 firm and broker-dealer registered with the SEC. John J. Fiero
20 was the sole registered representative of Fiero Brothers. As
21 such, the Fieros were subject to the regulations and discipline
22 of NASD.

23 On February 6, 1998, NASD's Department of Enforcement
24 initiated disciplinary proceedings against the Fieros, the merits
25 of which are not pertinent to this appeal. On December 6, 2000,
26 an NASD hearing panel held that the Fieros had violated Section
27 10(b) of the Exchange Act, Rule 10b-5, and FINRA Conduct Rules

1 2110, 2120, and 3370. The hearing panel expelled Fiero Brothers,
2 barred Fiero from associating with any FINRA-member firm in any
3 capacity, and fined the Fieros \$1,000,000 plus costs, jointly and
4 severally.

5 On appeal, the NAC affirmed the hearing panel's decision in
6 its entirety. John Fiero, Nat'l Adjudicatory Council No.
7 CAF980002, 2002 WL 31476976, at *34 (Oct. 28, 2002). The Fieros
8 did not appeal the NAC's decision to the SEC.

9 c) State Court Proceedings

10 After the Fieros refused to pay the fine, FINRA commenced an
11 action on December 22, 2003, in New York Supreme Court. Fin.
12 Indus. Regulatory Auth., Inc. v. Fiero, 882 N.E.2d 879, 880-81
13 (N.Y. 2008). On September 12, 2005, the Supreme Court concluded
14 that "NASD's claim [was] firmly based on ordinary principles of
15 contract law" because the Fieros had "expressly agreed to comply
16 with all NASD rules, including the imposition of fines and
17 sanctions" when they voluntarily executed the NASD registration
18 forms. Nat'l Ass'n of Sec. Dealers, Inc. v. Fiero, 2005 N.Y.
19 Slip Op. 30161 [U], at 2, 2005 WL 6012105 (Sept. 12, 2005). The
20 Supreme Court further stated that "New York state courts have
21 long recognized the right of a private membership organization to
22 impose fines on its members, when authorized to do so by statute,
23 charter or by-laws," and that "NASD is not 'just a private club,'
24 but a self-regulatory organization, federally-mandated under . .
25 . the Exchange Act to discipline its members and enforce the

1 federal securities laws as well as its own SEC-approved rules."
2 Id. at 4-5. On May 11, 2006, the Supreme Court awarded the NASD
3 a judgment of \$1,329,724.54. Nat'l Ass'n of Sec. Dealers, Inc.
4 v. Fiero, 2006 N.Y. Slip Op. 30302 [U], 2006 WL 5251396 (May 11,
5 2006).

6 The First Department of the New York Appellate Division
7 affirmed the Supreme Court's decision. Nat'l Ass'n of Sec.
8 Dealers, Inc. v. Fiero, 827 N.Y.S.2d 4, 5 (1st Dep't 2006). The
9 New York Court of Appeals granted the Fieros leave to appeal, and
10 on February 7, 2008, reversed on the ground that the state courts
11 lacked subject matter jurisdiction. Fiero, 882 N.E.2d at 881-82.
12 The court explained that the FINRA complaint constituted an
13 action to enforce a liability or duty created under the Exchange
14 Act, and therefore, fell within the exclusive jurisdiction of the
15 federal courts pursuant to 15 U.S.C. § 78aa. Id. at 882.

16 d) Federal Court Proceedings

17 On February 8, 2008, the day after the New York Court of
18 Appeals issued its ruling, the Fieros filed the instant action
19 seeking a declaratory judgment that, inter alia, FINRA has no
20 authority to collect fines through judicial proceedings.³ FINRA
21 thereafter filed a counterclaim, seeking to enforce the fine
22 under a breach of contract theory. Both parties moved to dismiss

³ Even prior to the Court of Appeals' ruling, the Fieros had brought an action in the Southern District, which has been voluntarily dismissed without prejudice pursuant to Fed. R. Civ. P. 41(a).

1 the complaint and counterclaim, respectively.

2 On March 30, 2009, the district court granted FINRA's motion
3 to dismiss the Fieros' claim, denied the Fieros' motion to
4 dismiss FINRA's counterclaim, and instructed the clerk to enter
5 judgment in favor of FINRA.⁴

6 DISCUSSION

7 We review a district court's grant of a motion to dismiss de
8 novo. Chase Grp. Alliance v. City of N.Y. Dep't of Fin., 620
9 F.3d 146, 150 (2d Cir. 2010). Our review of a district court's
10 legal conclusions, including the interpretation of a federal
11 statute, is also de novo. United States v. Fuller, 627 F.3d 499,
12 503 (2d Cir. 2010).⁵

⁴ However, the court's order did not specify the amount of the judgment. On April 2, 2009, the district court issued a more detailed decision and order, setting forth its findings, reasoning, and conclusions as to the earlier judgment, but similar to its earlier order, this decision did not specifically direct entry of a judgment for a specific amount of money. Fiero v. Fin. Indus. Regulatory Auth., Inc., 606 F. Supp. 2d 500 (S.D.N.Y. 2009). The Fieros and FINRA both timely filed their notices of appeal on April 14, 2009 and April 29, 2009, respectively.

On April 17, 2009, the district court requested a limited remand to correct the omission of the judgment amount. On July 15, 2009, we granted the district court's request, and, thereafter the district court directed the clerk to enter a judgment in favor of FINRA in the amount of \$1,010,809.25 with costs and interest. Both parties made timely requests to reinstate the appeals, which we granted on August 12, 2009.

⁵ Although both parties had agreed that federal jurisdiction existed, the district court sua sponte decided that it lacked federal question jurisdiction under 28 U.S.C. § 1331, but had diversity jurisdiction under 28 U.S.C. § 1332. Fiero, 606 F. Supp. 2d at 509. We disagree with the district court's conclusion that it lacked federal question jurisdiction.

For jurisdiction to arise under Section 1331, "the claim as stated in the complaint" must "arise[] under the Constitution or laws of the United States." S. New England Tel. Co. v. Global NAPs Inc., 624 F.3d 123, 132 (2d Cir. 2010) (quoting Carlson v. Principal Fin. Grp., 320 F.3d 301, 306 (2d Cir. 2003) (internal quotation mark omitted)). The Fieros seek a declaratory judgment under 28 U.S.C. § 2201, "that FINRA has no authority to obtain a money judgment based on" a disciplinary fine imposed pursuant to FINRA's powers under the Exchange Act. See Compl. ¶¶ 1, 16, and 30. On its face, the complaint states a claim under the Exchange Act. We have federal question jurisdiction to determine whether FINRA has authority to collect through

1 The Fieros argue that while the Exchange Act and FINRA's
2 rules and bylaws authorize FINRA to impose sanctions on its
3 members, it has no authority to bring judicial actions to collect
4 monetary sanctions. FINRA argues that it has this authority
5 under the Exchange Act and from a FINRA rule submitted to, and
6 not disapproved by, the SEC in 1990 ("1990 Rule Change"). See
7 Notice of Filing and Immediate Effectiveness of Proposed Rule
8 Change by NASD Relating to the Collection of Fines and Costs in
9 Disciplinary Proceedings, Exchange Act SEC Release No. 28227, 46
10 S.E.C. Docket 1049 (July 18, 1990) (hereinafter "SEC Notice of
11 1990 Rule Change"). We discuss each argument seriatim.

12 a) FINRA's Authority Under the Exchange Act
13

14 The first question is whether the Exchange Act provides
15 FINRA with the necessary authority. We hold that it does not.

16 Under Section 15A(b) of the Exchange Act, SRO's have a
17 statutory authority and obligation to "appropriately
18 discipline[]" their members for violation of any provision of the
19 Exchange Act, the rules or regulations promulgated thereunder, or
20 their own rules, "by expulsion, suspension, limitation of
21 activities, functions, and operations, fine, censure, being
22 suspended or barred from being associated with a member, or any

judicial proceedings fines levied pursuant to the Exchange Act. See Franchise Tax Bd. v. Constr. Laborers Vacation Trust, 463 U.S. 1, 19 n.19 (1983) (explaining that federal question jurisdiction exists over a declaratory judgment action if, inter alia, the defendant could have brought a coercive claim under federal law against the plaintiff); see also Carlson, 320 F.3d at 307 (holding that the district court has subject matter jurisdiction because it "is clear that the complaint, on its face, seeks relief under ERISA").

1 other fitting sanction." 15 U.S.C. § 78o-3(b)(7). However,
2 there is no express statutory authority for SRO's to bring
3 judicial actions to enforce the collection of fines.⁶

4 In the present context the omission is not insignificant.
5 The core issue, of course, is congressional intent, Touche Ross &
6 Co. v. Redington, 442 U.S. 560, 568 (1979), and, in the
7 discussion that follows, we explain why we believe that Congress
8 did not intend to empower FINRA to bring judicial actions to
9 enforce its fines.

10 The statutory scheme carefully particularizes an array of
11 available remedies, including permissible actions in the federal
12 courts. These include, of course, a variety of actions by
13 private parties for damages. 15 U.S.C. §§ 77k-77l, 78i(f),
14 78t(b); see Redington, 442 U.S. at 571-72 (discussing generally
15 private rights of action in the Securities Exchange Act).

16 Also, Section 21(d) of the Exchange Act provides express
17 statutory authority for the SEC to seek judicial enforcement of
18 penalties. See 15 U.S.C. § 78u(d). More specifically, the SEC
19 "may in its discretion bring an action" to enjoin any person who
20 "is engaged or is about to engage in acts or practices
21 constituting a violation" of, inter alia, any provision of the
22 Exchange Act, the rules or regulations thereunder, or the rules

⁶ It is worth noting that the power granted to SRO's by Section 15A of the Exchange Act to discipline their members applies to all SRO's, and not just FINRA.

1 of a national securities exchange or registered securities
2 association of which such person is a member from such practices.
3 Id. § 78u(d)(1). Moreover, the SEC has explicit authority to
4 seek monetary penalties for violations of the Exchange Act, the
5 rules and regulations promulgated thereunder, or for the
6 violation of a cease and desist order. Id. § 78u(d)(3)(A).
7 Under Section 21(e) of the Exchange Act, the SEC may also seek
8 "writs of mandamus, injunctions, and orders" from the federal
9 courts commanding any person to comply with, inter alia, "the
10 provisions of [the Exchange Act], the rules, regulations, and
11 orders thereunder, the rules of a national securities exchange or
12 registered securities association of which such person is a
13 member or person associated with a member" Id. § 78u(e).
14 Under Section 21(f), however, the SEC is prohibited from bringing
15 "any action pursuant to subsection (d) or (e) of this section
16 against any person for violation of, or to command compliance
17 with, the rules of a self-regulatory organization . . . unless it
18 appears to the Commission that (1) such self-regulatory
19 organization . . . is unable or unwilling to take appropriate
20 action against such person in the public interest and for the
21 protection of investors, or (2) such action is otherwise
22 necessary or appropriate in the public interest or for the
23 protection of investors." Id. § 78u(f).⁷

⁷ The SEC takes the position that it has the authority to bring an action in a federal district court to enforce any order it issues that affirms sanctions, including fines, imposed by FINRA. See Delegation of Authority to the Office of the General Counsel, SEC Release No. 42,488, 71 S.E.C. Docket

1 Therefore, when Congress passed the Exchange Act, and to
2 this date, Sarbanes-Oxley Act of 2002, § 3(b), (amending 15
3 U.S.C. § 78u); Dodd-Frank Wall Street Reform Act, Pub. L. No.
4 111-203, § 929P, 124 Stat. 1376, 1862-63 (2010) (amending 15
5 U.S.C. § 78u), it was well aware of how to grant an agency access
6 to the courts to seek judicial enforcement of specific sanctions,
7 including monetary penalties. 15 U.S.C. § 78u(d)(3)(A); see,
8 e.g., SEC v. Rosenthal, Nos. 10-1204-cv(L); 10-1253 (con.), 2011
9 WL 2271743 (2d Cir. June 9, 2011); SEC v. Tx. Gulf Sulphur Co.,
10 446 F.2d 1301, 1307 (2d Cir. 1971).

11 In contrast, there are no explicit provisions in the statute
12 authorizing SRO's to seek judicial enforcement of the variety of
13 sanctions they can impose. This is significant evidence that
14 Congress did not intend to authorize FINRA to seek judicial
15 enforcement to collect its disciplinary fines. Redington, 442
16 U.S. at 571-72 (not implying a private right of action where
17 elsewhere in the Exchange Act Congress demonstrated the ability
18 and explicit intent to create private rights of action).

19 We need not rely upon negative implications alone, however,
20 because there are statutory provisions that weigh heavily against
21 FINRA's claim of enforcement powers through court actions
22 alleging breach of contract. First, FINRA's sanctions are

1910 (March 2, 2000); 15 U.S.C. § 78u(e)(1). Although several other Courts of Appeals have affirmed the SEC's authority to enforce FINRA-imposed sanctions pursuant to Section 21(e), see, e.g., SEC v. Mohn, 465 F.3d 647, 651-52 (6th Cir. 2006); SEC v. McCarthy, 322 F.3d 650, 655 (9th Cir. 2003); SEC v. Vittor, 323 F.3d 930 (11th Cir. 2003); and Lang v. French, 154 F.3d 217, 222 (5th Cir. 1998), this issue is not before us on this appeal.

1 appealable by an aggrieved party to the SEC and thereafter to the
2 United States Courts of Appeals. Had Congress intended judicial
3 enforcement, it would surely have provided for some specific
4 relief other than leaving SRO's to commonlaw proceedings in state
5 courts or in federal district courts under diversity
6 jurisdiction.⁸ Second, where FINRA enforces statutory or
7 administrative rules, or enforces its own rules promulgated
8 pursuant to statutory or administrative authority, it is
9 exercising the powers granted to it under the Exchange Act.
10 Indeed, FINRA's powers in that regard are subject to divestment
11 by the SEC under Section 19(g)(2) of that Act. However, Congress
12 gave the federal courts exclusive jurisdiction to enforce the
13 Exchange Act, 15 U.S.C. § 78aa, and FINRA's breach of contract
14 theory undermines that provision. FINRA contract enforcement
15 actions may bristle with Exchange Act legal issues because the
16 most serious fines levied by FINRA will be for member violations
17 of the Act. For example, the Fieros were charged with a
18 violation of Section 10(b) of that Act. State court enforcement
19 of FINRA fines might well, therefore, entail interpretation of
20 the Exchange Act notwithstanding the exclusive jurisdiction of
21 the federal courts.

22 One might argue that an inference of congressional intent to

⁸ One court has even held that NASD is not an "aggrieved person" in a Court of Appeals review proceeding, and that NASD was thus unable to bring a petition for review of an SEC decision vacating an NASD disciplinary decision. Nat'l Ass'n of Sec. Dealers, Inc. v. SEC, 431 F.3d 803, 809-10 (D.C. Cir. 2005).

1 authorize such legal actions by FINRA can be drawn from the
2 seemingly inexplicable nature of a gap in the FINRA enforcement
3 scheme: fines may be levied but not collected. However, the gap
4 does not support an inference of inadvertent omission because
5 significant underenforcement of the securities laws and FINRA
6 rules is hardly the inevitable result of FINRA's inability to
7 bring fine-enforcement actions. FINRA fines are already enforced
8 by a draconian sanction not involving court action. One cannot
9 deal in securities with the public without being a member of
10 FINRA. When a member fails to pay a fine levied by FINRA, FINRA
11 can revoke the member's registration, resulting in exclusion from
12 the industry. Moreover, where a fine is based on a violation of
13 the Exchange Act, the violator will also face a panoply of
14 private and SEC remedies. See, e.g., 15 U.S.C. §§ 77k-77l, 78i,
15 78j(b).

16 Finally, our conclusion is amply supported by NASD's
17 longstanding practices. It has always relied exclusively upon
18 its powers to revoke the registration of or deny reentry into the
19 industry to punish members who do not comply with sanctions.
20 U.S. Gen. Accounting Office, SEC and CFTC: Most Fines Collected,
21 But Improvements Needed in the Use of Treasury's Collection
22 Service 11 (2001). So far as we can tell, it was not until 1990
23 that the NASD sought to enforce fines or any other sanction
24 through judicial actions in its own right. NASD (or any other
25 SRO) may never even have claimed to have the power to do so until

1 1990. In that year, as discussed infra, NASD proposed a rule and
2 successfully asked the SEC not to disapprove it. The rule
3 notified the public of a new NASD policy of bringing court
4 actions in its name to collect fines. NASD, Notice to Members
5 90-21, available at
6 <http://www.finra.org/Industry/Regulation/Notices/Pre-1996/>. This
7 rule, and its effect, are discussed in the next subsection. And,
8 even after the change in policy in 1990 -- the effect of which
9 turns in part on the question of statutory authority -- the
10 action against the Fieros is said to be the first case brought
11 under that policy. Appellant's Br. at 10.

12 Such a longstanding practice supports an inference that NASD
13 believed that it lacked judicial enforcement power. As the
14 Supreme Court has stated,

15 Authority actually granted by Congress of
16 course cannot evaporate through lack of
17 administrative exercise. But just as
18 established practice may shed light on the
19 extent of power conveyed by general statutory
20 language, so the want of assertion of power
21 by those who presumably would be alert to
22 exercise it, is equally significant in
23 determining whether such power was actually
24 conferred.

25 Fed. Trade Comm'n v. Bunte Bros., 312 U.S. 349, 352 (1941); see
26 also Bankamerica Corp. v. United States, 462 U.S. 122, 131 (1983)
27 (finding that "the Government's failure for over 60 years to
28 exercise the power it now claims . . . strongly suggests that it
29 did not read the statute as granting such power").

30 Moreover, NASD's longstanding reliance upon these other

1 substantial enforcement methods was known to Congress, and
2 Congress left that reliance unaltered. This lack of action
3 further indicates that FINRA is not authorized to enforce the
4 collection of its fines through the courts. See Merrill Lynch,
5 Pierce, Fenner & Smith, Inc. v. Curran, 456 U.S. 353, 381-82
6 (1982) (noting that "an implied cause of action under the
7 [Commodities Exchange Act] was a part of the 'contemporary legal
8 context' in which Congress legislated," and that "[i]n that
9 context, the fact that a comprehensive reexamination and
10 significant amendment of the [Commodities Exchange Act] left
11 intact the statutory provisions under which the federal courts
12 had implied a cause of action is itself evidence that Congress
13 affirmatively intended to preserve that remedy" (internal
14 citations omitted)). The situation here is different from
15 Merrill Lynch in that a failure to bring actions, rather than the
16 bringing of actions, was involved, but the principle of
17 congressional acquiescence is the same.

18 In sum, the issue is one of legislative intent, and we
19 conclude that the heavy weight of evidence suggests that Congress
20 did not intend to empower FINRA to bring court proceedings to
21 enforce its fines.

22 b) FINRA's Authority Under the 1990 Rule
23

24 On April 10, 1990, and as amended on June 20, 1990, FINRA
25 filed a rule with the SEC pursuant to Section 19(b)(1) of the
26 Exchange Act. Self-Regulatory Organizations; Notice of Filing

1 and Immediate Effectiveness of Proposed Rule Change by National
2 Association of Securities Dealers, Inc. Relating to the
3 Collection of Fines and Costs in Disciplinary Proceedings,
4 Exchange Act Release No. 28227, 46 SEC Docket 1049 (July 18,
5 1990), 1990 WL 320480. The proposal provided notification that
6 the NASD "intends to pursue other available means for the
7 collection of fines and costs imposed . . . in disciplinary
8 decisions" on or after July 1, 1990. Id. at *1. The NASD
9 advised that should "its own internal efforts for the collection
10 of fines . . . fail," it may refer a matter "to external
11 collection agencies and in appropriate situations, . . . seek to
12 reduce such fines to a judgment." Id. at *1 n.2. Along with its
13 SEC filing, the NASD issued a notice to its members in April
14 1990, informing them of its new policy and outlining how the
15 policy would be implemented. See NASD, Notice to Members 90-21,
16 available at
17 <http://www.finra.org/Industry/Regulation/Notices/Pre-1996/>. The
18 notice became effective on July 1, 1990. Id. (noting that the
19 "NASD will not pursue the collection of fines and costs assessed
20 in cases concluded prior to July 1, 1990").

21 In October 1999, NASD sent a second notice to its members
22 notifying them that it would "pursue the collection of any fine
23 in sales practice cases, even if an individual is barred, if
24 . . . there has been widespread, significant, and identifiable
25 customer harm; or the respondent has retained substantial

1 ill-gotten gains."⁹ NASD, Notice to Members 99-86, available at
2 <http://www.finra.org/Industry/Regulation/Notices/1999/p004067>.

3 FINRA claims that the 1990 Rule Change constitutes authority
4 for judicial enforcement of its fines. This claim is something
5 of an exaggeration. The 1990 Rule Change does not even purport
6 to be newly granted authorization from the SEC to FINRA to bring
7 such judicial actions. Rather, it appears to assume a pre-
8 existing power and to serve only as a notice of a new policy
9 under that power.

10 Having found no such pre-existing power, we may nevertheless
11 assume for purposes of analysis that the 1990 Rule Change, if
12 properly obtained, constitutes such authorization.¹⁰ However,
13 for FINRA to have obtained authority under the 1990 Rule Change
14 to enforce the collection of its disciplinary fines through
15 judicial proceedings, the rule must have been properly
16 promulgated under the procedures established by the Exchange Act.
17 It was not.

18 Section 19(b) of the Exchange Act establishes the mechanism
19 by which SRO's can change their governing rules. See 15 U.S.C. §
20 78s(b). To initiate the process, an SRO must file any proposed
21 rule change with the SEC, "accompanied by a concise general

⁹ This second notice to members was issued after the NASD enforcement action against the Fieros was initiated, but before the Fieros chose not to pursue an appeal to the SEC.

¹⁰ We of course intimate no opinion on the validity of a properly promulgated rule authorizing fine collection through judicial proceedings.

1 statement of the basis and purpose of such proposed rule change.”
2 Id. § 78s(b)(1).¹¹ The SEC is then required to publish notice of
3 the proposed rule change and give interested individuals an
4 opportunity to comment prior to either approving or disapproving
5 the rule. Id.

6 Under this system, established by Congress in 1975, all new
7 substantive rules and modification of existing rules for SRO’s
8 must go through a notice and comment period and obtain SEC
9 approval before becoming effective. Securities Acts Amendments
10 of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified as amended at
11 15 U.S.C. §§ 78a to 80b-4 (1975)); Credit Suisse First Boston
12 Corp. v. Grunwald, 400 F.3d 1119, 1130 (9th Cir. 2005). A
13 substantive rule -- or legislative one, as it is sometimes called
14 in this Circuit -- creates “new law, right, or duties, in what
15 amounts to a legislative act.” N.Y. State Elec. & Gas Corp. v.
16 Saranac Power Partners, L.P., 267 F.3d 128, 131 (2d Cir. 2001)
17 (citations and internal quotation mark omitted) (defining
18 substantive rule in the context of the Administrative Procedure
19 Act).

20 Congress also included an exception to the comment and
21 notice requirement of § 19(b)(1) for “‘House-Keeping’ rules and
22 other rules which do not substantially affect the public interest

¹¹ Congress’s intention in adopting § 19(b)(1) was to impose on SRO’s
“the same standards of policy justification that the Administrative Procedure
Act imposes on the SEC.” S. REP. No. 94-75 (1975), reprinted in 1975
U.S.C.C.A.N. 179, 207-08, 1975 WL 12347, at *29.

1 or the protection of investors." 121 Cong. Rec. 700-183 (1975)
2 (comments of Sen. Harrison Williams); see also Saranac Power
3 Partners, 267 F.3d at 131 (defining interpretive rules as those
4 which "do not create rights, but merely clarify an existing
5 statute or regulation" (citations and internal quotation marks
6 omitted)); Grunwald, 400 F.3d at 1130 n.11. Such proposed rule
7 changes take immediate effect upon filing with the SEC. 15
8 U.S.C. § 78s(b)(3)(A). In particular, the rule change becomes
9 effective on filing with the SEC if the SRO designates the
10 proposed rule as:

11 (i) constituting a stated policy, practice,
12 or interpretation with respect to the
13 meaning, administration, or enforcement of an
14 existing rule of the self-regulatory
15 organization, (ii) establishing or changing a
16 due, fee, or other charge imposed by the
17 self-regulatory organization on any person,
18 whether or not the person is a member of the
19 self-regulatory organization, or (iii)
20 concerned solely with the administration of
21 the self-regulatory organization or other
22 matters which the Commission [may specify].
23

24 Id.

25
26 In proposing the 1990 Rule Change, the NASD designated it as
27 such a "House-Keeping" rule, "one constituting a stated policy
28 with respect to the enforcement of an existing rule of the NASD
29 under § 19(b)(3)(A)(i) of the [Exchange] Act." See Self-
30 Regulatory Organizations; Notice of Filing and Immediate
31 Effectiveness of Proposed Rule Change by National Association of
32 Securities Dealers, Inc. Relating to the Collection of Fines and
33 Costs in Disciplinary Proceedings, Exchange Act Release No.

1 28227, 46 SEC Docket 1049 at *1, 1990 WL 320480. Thus, the rule
2 was to become effective upon the SEC's receipt of the filing. 15
3 U.S.C. § 78s(b)(3)(A).

4 We, however, are not bound by the NASD's characterization as
5 to whether the 1990 Rule Change affected the substantive rights
6 of members. Brodsky v. U.S. Nuclear Regulatory Comm'n, 578 F.3d
7 175, 182 (2d Cir. 2009) ("The particular label placed upon [an
8 order] by [an agency] is not necessarily conclusive, for it is
9 the substance of what the [agency] has purported to do and has
10 done which is decisive." (quoting Columbia Broad. Sys., Inc. v.
11 United States, 316 U.S. 407, 416 (1942))).

12 Prior to the 1990 Rule Change, as discussed, there was no
13 existing SEC rule or statute that authorized the NASD to initiate
14 judicial proceedings to enforce the collection of its
15 disciplinary fines. Furthermore, the NASD had a longstanding
16 practice of not seeking to enforce collection through judicial
17 actions. Indeed, even subsequent to the 1990 Rule Change, NASD
18 did not rely on it to ask courts to enter judgments based on its
19 disciplinary fines. For example, in 1998, it sought the SEC's
20 assistance in obtaining court orders to direct violators owing
21 NASD fines to pay these amounts. See U.S. Gen. Accounting
22 Office, SEC and CFTC: Most Fines Collected, But Improvements
23 Needed in the Use of Treasury's Collection Service 11 (2001). In
24 response, the SEC agreed to seek court orders under Exchange Act
25 § 21(e)(1) to enforce the NASD's disciplinary fines, but only for

1 cases that it affirmed on appeal and that met other specific
2 requirements. Id.

3 This background and the various statutory provisions
4 discussed above demonstrate that the 1990 Rule Change was not
5 simply a stated policy change under 15 U.S.C. § 78s(b)(3)(A) that
6 could bypass the required notice and comment period of Section
7 19(b). Rather, it was a new substantive rule that affected the
8 rights of barred and suspended members to stay out of the
9 industry and not pay the fines imposed on them in prior
10 disciplinary proceedings. As a result, the NASD was required to
11 file the new substantive rule with the SEC under 15 U.S.C. §
12 78s(b)(1) for publication of a notice and comment period.
13 Because the NASD improperly designated the 1990 Rule Change, it
14 was never properly promulgated and cannot authorize FINRA to
15 judicially enforce the collection of its disciplinary fines.

16 CONCLUSION

17 For the foregoing reasons, we reverse the judgment
18 dismissing the appellants' declaratory judgment complaint and
19 vacate the judgment entered in favor of the appellee.