IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

THADDEUS J. NORTH, and)
MARK POMPEO,)
) Civil Action No. 15-494 RMC
Plaintiffs,)
)
v.)
)
SMARSH, INC. and FINANCIAL INDUSTRY)
REGULATORY AUTHORITY, INC.,)
DEPARTMENT OF ENFORCEMENT,)
)
Defendants.)

FINRA'S MOTION TO DISMISS

Defendant Financial Industry Regulatory Authority, Inc. ("FINRA") moves the Court to dismiss all pending claims against FINRA and deny all injunctive relief for lack of subject matter jurisdiction under Fed. R. Civ. P. 12(b)(1) and 12(h)(3) and for failure to state a claim upon which relief can be granted pursuant to Fed. R. Civ. P. 12(b)(6). This Motion is supported by the accompanying Memorandum of Points and Authorities and by attached Exhibits 1 through 4.

Dated: April 29, 2015

Respectfully submitted,

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REGULATORY AUTHORITY, INC.,	)	
DEPARTMENT OF ENFORCEMENT,	)	
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Pursuant to Federal Rules of Civil Procedure 12(b)(1), 12(b)(h)(3), and 12(b)(6), Defendant Financial Industry Regulatory Authority, Inc.[1] ("FINRA") submits this memorandum of law in support of its motion to dismiss Plaintiffs' Thaddeus J. North ("Mr. North") and Mark P. Pompeo ("Mr. Pompeo") (collectively, "Plaintiffs") Complaint.

I. INTRODUCTION AND SUMMARY OF ARGUMENT

Plaintiffs seek to enjoin two ongoing FINRA enforcement proceedings and seek at least $3,000,000 in damages against FINRA in its capacity as a securities regulator on the grounds that FINRA obtained and relied on allegedly spoliated emails and email reports from Plaintiffs' former firms' email vendor – Defendant Smarsh, Inc. ("Smarsh") - in pursuing disciplinary actions against Plaintiffs. In other words, Plaintiffs have sued FINRA for performing its regulatory duties mandated by the Securities Exchange Act of 1934, 15 U.S.C. §78a, *et seq*. ("Exchange Act").[2]

Plaintiff's Complaint should be dismissed for the following reasons:[3]

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[1] FINRA was formerly known as National Association of Securities Dealers, Inc. ("NASD"). On July 30, 2007, NASD acquired the member regulation, enforcement and arbitration operations of the New York Stock Exchange and changed its name to FINRA.

[2] This is not the first time Mr. North and his counsel have prematurely and improperly sought to enjoin these FINRA disciplinary proceedings. On December 10, 2014, in an action styled "*In re Thaddeus J. North*", United States Court of Appeals for the D.C. Circuit, Case No. 14-1274, Mr. North filed an "Emergency Petition for Mandamus, Temporary and Permanent Injunctive Relief, and Stay of Proceedings Before the Financial Industry Regulatory Authority." The Petition challenged the determinations of two separate FINRA Hearing Officers in the FINRA cases regarding the same allegedly spoliated records at issue in the current Complaint, and sought to permanently enjoin the FINRA cases. The next day, on December 11, 2014, the Appeals Court Ordered that the Petition be denied finding that mandamus relief was not warranted. *See* December 11, 2014 Order, attached as Exhibit 1.

[3] For the same reasons FINRA's Motion to Dismiss should be granted, Plaintiffs have failed to establish any of the required elements for injunctive relief.

1. This Court lacks subject matter jurisdiction under Fed. R. Civ. P. 12(b)(1) and 12(h)(3) because the Exchange Act provides the exclusive judicial remedy for complaints arising from FINRA disciplinary proceedings and requires Plaintiffs to exhaust their administrative remedies. 15 U.S.C. § 78s, 78y; *See Marchiano v. NASD, Inc.*, 134 F.Supp.2d 90 (D. D.C. 2001); s*ee also McGinn, Smith & Co.. Inc. v. FINRA*, 786 F.Supp. 2d 139, 146 (D. D.C. 2011).
2. FINRA "is absolutely immune from suit for the improper performance of regulatory, adjudicatory, or prosecutorial duties delegated by the SEC." *In re Series 7 Broker Qualification Exam Scoring Litigation*, 548 F.3d 110, 114 (D.C. Cir. 2008). No court has ever allowed tort claims to proceed against FINRA related to its enforcement duties under the Exchange Act.
3. Neither the Exchange Act, nor any provision of the federal securities laws expressly provides for a cause of action against an SRO like FINRA for acts or omissions in connection with its regulatory duties. *See, e.g., In re Series 7 Broker Qualification Exam Scoring Litigation, supra*, 548 F.3d at 115 ("The elaboration of duties, allowance of delegation and oversight by the SEC, and multi-layered system of review show Congress's desire to protect SROs from liability for common law suits").
4. Even if such a claim were viable, Plaintiffs fail to state a claim of "negligent spoliation" claim against FINRA. *See Cook v. Children's National Medical* Center, 810 F.Supp. 2d 151, 155 (D. D.C. 2011); *see also Holmes v. Amerex Rent-A-Car*, 180 F.3d 294, 297 (D.C. Cir. 1999).

For these reasons, as further discussed below, FINRA should be dismissed from this case.

II. FACTS

A. FINRA and Its Role in Securities Regulation

FINRA is a private not-for-profit Delaware corporation and a self-regulatory organization ("SRO") registered with the Securities Exchange Commission ("SEC") as a national securities association pursuant to the Maloney Act of 1938, 15 U.S.C. § 78o-3, *et seq*., amending the Exchange Act. *See McGinn, Smith & Co., Inc. v. FINRA*, 786 F.Supp.2d 139, 141 (D. D.C. 2011). FINRA is part of the Exchange Act's interrelated and comprehensive mechanism for regulating the securities markets. *See Domestic Sec., Inc. v. SEC*, 333 F.3d 239, 242 (D.C. Cir. 2003). The SEC must approve all FINRA rules.[4] 15 U.S.C. § 78s(b) and (c). The SEC cannot approve a FINRA Rule or amendment unless it is consistent with the Exchange Act and the rules and regulations promulgated thereunder. 15 U.S.C. § 78s(b). The Exchange Act requires FINRA to comply with the Act, SEC rules, and FINRA's own rules. 15 U.S.C. § 78s(g), (h).

FINRA exercises disciplinary authority over its members and is required to enforce compliance with securities laws and FINRA rules. *See, e.g.,* 15 U.S.C. § 78o-3(b) and (h); § 78s; *D.L. Cromwell Inv., Inc. v. NASD Regulation, Inc.*, 279 F.3d 155, 157 (2d Cir. 2002) (FINRA is charged with "conducting investigations and commencing disciplinary proceedings against [FINRA] member firms and their associated member representatives relating to compliance with the federal securities laws and regulations"), *cert. denied*, 537 U.S. 1028 (2002). The FINRA Code of Procedure, approved by the SEC, governs FINRA disciplinary proceedings against

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[4] FINRA Rules are published by the SEC in the *Federal Register* when changes are proposed or approved; the current version of all FINRA Rules, including the Code of Procedure, is in the FINRA Manual and is publically available at http://finra.complinet.com/. As a courtesy, any FINRA Rule referenced in this Memorandum is attached in numerical order as Exhibit 2.

securities firms and registered representatives like Plaintiffs. FINRA rules "are part of the apparatus of federal securities regulation." *Kurz v. Fidelity Management & Research Co.*, 556 F.3d 639, 641 (7th Cir. 2009).

Disciplinary hearings are conducted by hearing panels pursuant to the FINRA Code of Procedure, found in the FINRA Manual beginning with Rule 9000. FINRA Hearing Officers, pursuant to FINRA Rule 9263, have the authority and obligation "to receive relevant evidence, and may exclude all evidence that is irrelevant, immaterial, unduly repetitious, or unduly prejudicial." FINRA Rule 9263, attached as Exhibit 2. Once the FINRA hearing panel has issued a final decision, the Exchange Act provides for a "three-tiered process of both administrative and judicial review of NASD [now FINRA] disciplinary proceedings." *Swirsky v. NASD,* 124 F.3d 59, 61 (1st Cir. 1997). First, an aggrieved party may appeal a hearing panel's final decision to the FINRA National Adjudicatory Council ("NAC"), which can affirm, modify or reverse the hearing panel's decision. FINRA Rule 9349(a), attached as Exhibit 2. Second, NAC decisions may be appealed to the SEC pursuant to 15 U.S.C. § 78s(d). Finally, after SEC review, the Exchange Act provides for direct appeal to the relevant United States Court of Appeals. *See* 15 U.S.C. § 78y; *see also McGinn, Smith, supra*, 786 F.Supp.2d at 141.

B. The Underlying FINRA Disciplinary Proceedings

There are two separate FINRA enforcement proceedings at issue in this litigation. On July 15, 2013, FINRA (New Orleans office) filed a Complaint against Respondents Leslie L. King, William E. Schloth, and Thaddeus J. North in Disciplinary Proceeding No. 2010025087302.[5] *See* Complaint, ¶3. Relevant for this summary, the FINRA Complaint alleges that from July 2009 through August 2011, Mr. North, as Chief Compliance Officer of Southridge

[5] Mr. Schloth and Ms. King settled the allegations against them with FINRA. Mr. Pompeo was never a respondent in the FINRA New Orleans proceeding. The only Respondent is Mr. North.

Investment Group, LLC, failed to: (1) establish and maintain a supervisory system that was appropriate for the review of electronic correspondence, (2) conduct an appropriate review of Firm email and Bloomberg messages, (3) institute a heightened review of King's Firm email and Bloomberg messages to monitor King and TC's business relationship; and (4) failed to report a relationship with a statutorily disqualified person. *Id.* Counsel for Plaintiffs has unsuccessfully raised the same issues set forth in this Complaint several times with the Hearing Officer in the FINRA disciplinary proceeding.[6] *See, e.g.,* Complaint, ¶40. Though Plaintiffs have attached the Declaration of John Barryhill to their Complaint (Exhibit 8), they neglect to tell the Court that the FINRA Hearing Officer specifically denied Mr. North's Motion Respecting Expert Testimony (which sought to admit expert testimony of Mr. Barryhill and other experts). The hearing on the merits was recently held on April 13 and April 14, 2015. No final decision has yet been issued.

On October 24, 2013, FINRA (Boston office) filed a Complaint against Respondent Thaddeus J. North in Disciplinary Proceeding No. 2012030527503.[7] *See* Complaint, ¶3. The Complaint alleges that from September 2011 through April 30, 2012, Mr. North, as Chief Compliance Officer of Ocean Cross Capital Markets, LLC, failed to enforce the firm's written supervisory procedures regarding the review of the firm's electronic correspondence and the recording of such review. *Id.* Counsel for Plaintiffs has unsuccessfully raised the same issues set forth in this Complaint several times with the Hearing Officer in the Boston case. *See, e.g.,*

[6] Counsel Constance Miller originally represented Respondent Leslie King (not a party to this case), but filed her notice of withdrawal on November 14, 2014. Ms. Miller entered her notice of appearance of behalf of Mr. North in the proceeding on June 5, 2014.

[7] As discussed below, Mr. Pompeo signed an AWC with FINRA to settle this case before a formal complaint was issued against him. The only Respondent in this proceeding is Mr. North.

Complaint, ¶¶40, 51-54. The merits hearing in that enforcement proceeding was just held on April 27, 2015. No final decision has yet been issued.

C. The AWC

As part of the disciplinary process, pursuant to FINRA Rule 9216, FINRA may settle cases against respondents prior to bringing formal Complaints against them by entering into a Letter of Acceptance, Waiver and Consent ("AWC"). *See* FINRA Rule 9216, attached as Exhibit 2. An AWC constitutes a complete and final settlement between FINRA and a regulated member firm or associated person. Rule 9216(a) sets forth the AWC Procedures and provides the framework for the AWC process. FINRA Rule 9216(a)(4) provides that once an AWC is accepted by FINRA, "it shall be deemed final and shall constitute the complaint, answer, and decision in the matter."

Plaintiffs relegate to a footnote that Mr. Pompeo "settled" the only FINRA disciplinary case to which he was a party (Disciplinary Proceeding No. 2012030527503). Complaint, ¶4, fn 3. On October 1, 2013, Mr. Pompeo signed an AWC related to FINRA's investigation of him in connection with potential violations of FINRA Rule 2010 and then NASD Conduct Rule 2210(d) (now FINRA Rule 2210) related to communications with the public. October 1, 2013 AWC, attached as Exhibit 3.[8] FINRA accepted this AWC on October 18, 2013. In signing this AWC, Mr. Pompeo agreed to a ten business-day suspension from association with any FINRA member

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[8] The Court may consider "documents upon which the plaintiff's complaint necessarily relies even if the document is produced not by the plaintiff in the complaint but by the defendant in a motion to dismiss." *Ward v. D.C. Dep't of Youth Rehab. Servs.*, 768 F. Supp. 2d 117, 119-20 (D. D.C. 2011) (citations and internal quotation marks omitted); *see also EEOC v. St. Francis Xavier Parochial School*, 117 F.3d 621, 624 (D.C. Cir. 1997) (In determining whether a complaint fails to state a claim, the Court may consider facts alleged in the complaint, any documents incorporated by reference in the complaint, and matters of which the Court may take judicial notice). Plaintiffs, although vaguely, refer to the AWC in the Complaint (fn3). Accordingly, the AWC attached as Exhibit 3 may be considered without converting this Motion to Dismiss into a Motion for Summary Judgment.

firm in any capacity and a $5,000 fine. He also expressly and irrevocably waived his right to have a Complaint issued against him by FINRA and waived his right to defend against the allegations made by FINRA, including pursuing his exhaustion rights under the Exchange Act. He also specifically accepted that the term that:

> I may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying directly or indirectly, any finding in this AWC or create the impression that the AWC is without factual basis. I may not take any position in any proceeding brought by or on behalf of FINRA, or to which FINRA is a party, that is inconsistent with any part of this AWC.

AWC, p. 4 (Paragraph III. C.4, Exhibit 3). The current Complaint buries the existence of this binding and final disciplinary record in footnote 3, and ignores the fact that Mr. Pompeo has forever waived his right to challenge the AWC or its contents in later litigation with FINRA in this Court or any other.[9]

III. ARGUMENT

For the reasons cited below, all injunctive relief should be denied and the Complaint against FINRA should be dismissed.

A. Motion to Dismiss Standards

Fed. R. Civ. P. 12(b)(1) provides that the court shall dismiss a complaint for lack of subject matter jurisdiction. To survive a motion to dismiss under 12(b)(1), Plaintiffs bear the burden to show that the Court has jurisdiction to hear their claims. Under Fed. R. Civ. P. 12(h)(3), "[w]henever it appears by suggestion of the parties or otherwise that the court lacks jurisdiction of the subject matter, it shall dismiss the action." Failure to exhaust administrative

[9] Because Mr. Pompeo waived any rights he had to challenge the AWC, it is egregiously improper for him to be a Plaintiff in this lawsuit. Notwithstanding the existence of the AWC, FINRA retains the plural "Plaintiffs'" throughout this Memorandum.

remedies deprives the Court of subject matter jurisdiction. *See, e.g., Daniels v. Union Pac. R.R. Co.*, 530 F.3d 936 (D.C. Cir. 2008).

To survive a motion to dismiss pursuant to Fed. R. Civ. P. 12(b)(6), a complaint must contain sufficient factual matter, accepted as true, to "'state a claim to relief that is plausible on its face.'" *Ashcroft v. Iqbal*, 556 U.S. 662, 129 S.Ct. 1937, 1949 (2009) (quoting *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570, 127 S.Ct. 1955 (2007)). The "tenet that a court must accept as true all of the allegations contained in a complaint is inapplicable to legal conclusions" and "threadbare recitals of the elements of a cause of action, supported by mere conclusory statements, do not suffice" to withstand the requirements of Federal Rules of Civil Procedure 8 and 12(b)(6). *Ashcroft,* 129 S.Ct. at 1949; *see also Trudeau v. FTC*, 456 F.3d 178, 193 (D.C. Cir. 2006) (quoting *Papasan v. Allain*, 478 U.S. 265, 286, 106 S. Ct. 2932 (1986)) (internal quotation marks omitted).

B. <u>This Court Lacks Subject Matter Jurisdiction To Enjoin Ongoing FINRA Disciplinary Proceedings.</u>

1. Plaintiffs Have Failed To Exhaust Their Administrative Remedies Required By The Exchange Act.

It is a "long settled rule of judicial administration that no one is entitled to judicial relief for a supposed or threatened injury until the prescribed administrative remedy has been exhausted." *Marchiano, supra,* 134 F.Supp.2d at 94 (quoting *Myers v. Bethlehem Shipbuilding Corp.*, 303 U.S. 41, 50-51, 58 S.Ct. 459 (1938)). "Exhaustion is required because it serves the twin purposes of protecting administrative agency authority and promoting judicial efficiency." *McCarthy v. Madigan*, 503 U.S. 140, 144, 112 S.Ct. 1081 (1992), *overruled in part on other grounds*, *Booth v. Churner*, 532 U.S. 731, 121 S.Ct. 1819 (2001). The exhaustion requirement avoids "premature interruption of the administrative process . . ." *Marchiano*, 134 F.Supp.2d at

94 (citing *McKart v. United* States, 395 U.S. 185, 193, 89 S.Ct. 1657 (1969)). The exhaustion requirement:

> [P]reserves the autonomy of the administrative agency by allowing it to exercise its expertise and discretion on appropriate matters . . . prevents parties from the 'frequent and deliberate flouting of administrative processes [which] could weaken the effectiveness of an agency' . . . promotes effective and efficient judicial review by ensuring that such review is of a fully developed factual record, and undertaken with the benefit of the agency's exercise of discretion or application of expertise . . . [and] promotes judicial efficiency in another way, since decision by the agency may obviate the need for a judicial decision on the issue . . .

Randolph-Sheppard Vendors of America v. Weinberger, 795 F.2d 90, 105 (D.C. Cir. 1986). Because this action has been filed before Plaintiffs exhausted their administrative remedies as required by the Exchange Act, this Court should dismiss the Complaint for lack of subject matter jurisdiction under Rules 12(b)(1) and 12(h)(3).

The Exchange Act establishes a mandatory process for resolving FINRA disciplinary actions, in which aggrieved persons must first exhaust their administrative remedies by concluding the FINRA disciplinary proceeding, pursuing appeal with FINRA's National Adjudicatory Council, and then, if dissatisfied, seek review before the SEC, and finally before a United States Court of Appeals. Pursuant to this statutorily-prescribed process, all arguments are adjudicated before FINRA (including appeal to the NAC), then the SEC, and ultimately a United States Court of Appeals. *See* 15 U.S.C. § 78s and § 78y*; see also, e.g., Marchiano*, 134 F. Supp.2d at 94-95; *Swirsky, supra*, 124 F.3d 59. Failure to exhaust the Exchange Act's review procedures "render[s] the district court without jurisdiction to entertain the suit." *First Jersey Securities, Inc. v. Bergen*, 605 F.2d 690, 700 (3d Cir. 1979), *cert. denied*, 444 U.S. 1074 (1980); *see also Merrill Lynch, Pierce, Fenner & Smith, Inc. v. NASD*, 616 F.2d 1363, 1368 (5th Cir.

1980) (reversing lower court's granting of preliminary injunction where plaintiff failed to exhaust administrative remedies).

This Court has determined that exhaustion requirements apply to FINRA disciplinary proceedings. *See Marchiano, supra*, 134 F. Supp.2d at 94. The *Marchiano* plaintiff sought to enjoin an ongoing FINRA disciplinary proceeding alleging that his constitutional and civil rights had been violated. *Id.* at 91-92. In granting FINRA's motion to dismiss, the *Marchiano* court agreed that plaintiff had failed to exhaust his administrative remedies set forth in the Exchange Act. *Id.* at 95 ("the court does not believe that this case is one of those rare and exceptional cases deserving of judicial review prior to the conclusion of administrative remedies"). The *Marchiano* Court specifically found that administrative process and remedies were not futile or inadequate (as alleged by plaintiff in that case and in this one) and disagreed that Marchiano would be irreparably harmed without immediate judicial review. *Id.*

Rather than launch a collateral attack on FINRA's enforcement proceedings in this Court, Plaintiffs are required to exhaust the Exchange Act's "process of both administrative and judicial review of disciplinary proceedings." *Swirsky*, 124 F.3d at 61. Associated persons do not fully exhaust their administrative remedies unless and until they complete all administrative tiers of review. *Id.* At no point, can associated persons like Plaintiffs opt out of the administrative process by asking this Court (or any other district court) for relief. *Id.* As the D.C. Circuit has concluded, the Exchange Act's "multiple layers of review evince Congress' intent to direct challenges . . . to the avenues Congress created." *In re Series 7 Broker Qualification Exam Scoring Litig.*, 548 F.3d 110, 114 (D.C. Cir. 2008).

This Complaint seeks to circumvent the comprehensive framework established by Congress for reviewing FINRA disciplinary proceedings. Indeed, Plaintiffs seek to bypass *all*

the tiers of review specified in the Exchange Act. The Complaint asks this Court to substitute its judgment for the: 1) FINRA Hearing Panel; 2) National Adjudicatory Council (which hears appeals of FINRA Hearing Panel Decisions); 3) the SEC (which hears appeals of NAC determinations); and 4) the United States Court of Appeals (which hears appeals of the SEC's Orders). *See, e.g.*, Complaint, ¶96 ("Messrs. North and Pompeo also seek permanent injunctive relief against FINRA precluding its use of spoliated ESI derived during the Relevant Period in any present or future proceedings against either Mr. North or Mr. Pompeo"). Both FINRA enforcement proceedings have had their merits hearing, but no final decisions have been issued. Thus, these cases have yet to conclude even the first tier of the administrative process set forth in the Exchange Act. This dispute does not belong in any court unless and until Plaintiffs exhaust the procedures established in the Exchange Act, and should thus be dismissed for lack of subject matter jurisdiction.

2. District Courts Lack Subject Matter Jurisdiction To Review FINRA's Disciplinary Actions.

This Court has also previously found that district courts lack jurisdiction over complaints seeking to enjoin ongoing FINRA disciplinary proceedings. *See McGinn, Smith & Co.. Inc., supra*, 786 F.Supp. 2d at 146. In *McGinn, Smith*, plaintiffs were the subject of an ongoing FINRA disciplinary proceeding and sought to stay an imminent disciplinary hearing until the conclusion of an SEC proceeding they were simultaneously defending. *Id.* at 143. Like this case, the *McGinn, Smith* plaintiffs argued that they would be irreparably harmed if the FINRA proceeding was allowed to move forward. *Id.* at 144. The *McGinn, Smith* court found that "the relief requested by Plaintiffs may affect the future jurisdiction of the Court of Appeals, and therefore the Court lacks subject matter jurisdiction under the rule in *TRAC*." *Id.* at 146 (referring to *Telecommunications Research and Action Center v. F.C.C.*, 750 F.2d 70 (D.C. Cir.

1984)). In reaching this ruling, the *McGinn, Smith* court relied on the *Marchiano* court's opinion that "Congress had vested the Court of Appeals with exclusive jurisdiction to review final NASD disciplinary rulings after they are reviewed by the SEC" and "a permanent injunction against enforcement, would prevent NASD from issuing a final order and therefore preclude review by the Court of Appeals." *Id.* at 93 (*TRAC, supra*). The *McGinn, Smith* court further reasoned that plaintiffs were "effectively challenging the manner in which FINRA has decided to investigate and conduct disciplinary hearings against them. Such an attack almost certainly implicates issues that would be addressed by the Court of Appeals upon final review of FINRA's ruling." *Id.* at 146 (citing *Ohio Edison Co. v. Zech*, 701 F.Supp. 4, 6 (D. D.C. 1988) (quotation omitted)).

Just as in the cases cited above, Plaintiffs seek to enjoin ongoing FINRA disciplinary hearings before they have even concluded. Their sole reason for seeking such drastic relief is the fact that they claim data provided by their former employers' email vendor to FINRA was somehow corrupted and it was improper for FINRA to have relied on such corrupted data in bringing disciplinary cases against them. Even if these allegations could be interpreted as fact (which FINRA does not concede), the mere fact that Plaintiffs have not been able to convince the Hearing Officers in both FINRA cases to exclude the data does not create subject matter in this Court. Nor does this Court have the jurisdiction to conclude, as Plaintiffs ask it to, that Plaintiffs were "wrongfully subject to disciplinary actions based on spoliated evidence." Complaint, ¶65. If this Court were to grant the requested injunctive relief, it would deprive the United States Court of Appeals for the D.C. Circuit of statutorily-mandated jurisdiction contrary to well-established law. Thus, all injunctive relief should be denied and the Complaint against FINRA should be dismissed.

C. <u>FINRA Has Absolute Immunity For Its Regulatory Acts.</u>

No court has ever imposed damages on FINRA for pursuing disciplinary cases against its member firms or registered representatives. This is because when FINRA "acts under the aegis of the Exchange Act's delegated authority, it is absolutely immune from suit for the improper performance of regulatory, adjudicatory, or prosecutorial duties delegated by the SEC." *In re Series 7*, *supra*, 548 F.3d at 114; *see also D'Alessio v. New York Stock Exchange, Inc.*, 258 F.3d 93, 105 (2d Cir. 2001) (holding that an SRO is "immune from liability for claims arising out of the discharge of its duties under the Exchange Act"), *cert. denied*, 534 U.S. 1066 (2001); *DL Capital Group LLC v. NASDAQ Stock Market, Inc.*, 409 F.3d 93, 99 (2d Cir. 2005) (holding that when an SRO engaged in conduct consistent with the powers delegated to it pursuant to the Exchange Act and the regulations and rules promulgated thereunder, SRO is immune from suit); *P'ship Exch. Sec. Co. v. NASD*, 169 F.3d 606, 608 (9th Cir. 1999) (holding that the NASD was protected by absolute immunity for its actions taken "under the authority delegated to it by the Exchange Act"); *Sparta Surgical Corp. v. NASD*, 159 F.3d 1209, 1215 (9th Cir. 1998) ("when Congress elected 'cooperative regulation' as the primary means of regulating the over-the-counter market, the consequence was that self-regulatory organizations had to enjoy freedom from civil liability when they acted in their regulatory capacity"); *Barbara v. NYSE*, 99 F.3d 49, 59 (2d Cir. 1996) ("[A]llowing suits against the Exchange arising out of the Exchange's disciplinary functions would clearly stand as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress, namely, to encourage forceful self-regulation of the securities industry"); *Scher v. NASD*, 386 F. Supp.2d 402, 406 (S.D.N.Y. 2005) (dismissing complaint against NASD and related entities because action barred by absolute immunity granted to NASD "for conduct falling within the scope of the of the [NASD's] regulatory and oversight functions"), aff'd 2007 U.S. App. LEXIS 4692 (2d Cir. 2007).

In *In re Series 7,* plaintiffs brought tort claims against FINRA for admitted mistakes made in connection with administering a securities licensing exam. Granting FINRA's motion to dismiss, the Court found that the "comprehensive structure set up by Congress is suggestive . . . of an intent to create immunity for such duties . . . The elaboration of duties, allowance of delegation and oversight by the SEC, and multi-layered system of review show Congress's desire to protect SROs from liability for common law suits." 548 F.3d at 115. The *In re Series 7* Court further reasoned that "Courts have consistently barred suits which seek monetary relief for actions taken by agency regulators – or those acting in their place – in performance of their regulatory, adjudicatory, or prosecutorial duties." *Id.*

Plaintiffs complain that FINRA has unfairly and improperly brought disciplinary cases against them by obtaining and relying on allegedly spoliated data received from their former firms' email vendor Defendant Smarsh. *See, e.g.,* Complaint, ¶¶90-103. Bringing and pursuing disciplinary cases against registered representatives in the securities industry falls squarely within FINRA's regulatory duties. 15 U.S.C. § 78o-3; §78s; *see also In re Series 7,* 548 F.3d at 115. This is the precise conduct to which SRO immunity is intended to apply. This action against FINRA is barred by FINRA's absolute regulatory immunity, and therefore FINRA should be dismissed from this case.

D. <u>No Private Right of Action Exists Against FINRA Under The Exchange Act For Its Regulatory Acts.</u>

Neither the Exchange Act nor any other statute provides for a cause of action against an SRO like FINRA for acts or omissions in connection with its duties as a securities regulator. To the contrary, courts, including the U.S. Court of Appeals for the D.C. Circuit hold that no private right of action exists against an SRO like FINRA for its regulatory acts. *See In re Series 7,* 548

F.3d at 114 ("By specifically adopting an appeals process which does not provide monetary relief, Congress has displaced claims for relief based on state common law"); *see also Spicer v. Chicago Board of Options Exchange, Inc.*, 977 F.2d 255, 260 (7th Cir. 1992) (declining to imply a private right of action in section of Exchange Act "against an [SRO] for violating or failing to enforce its own rules"); *MM&S Financial, Inc. v. NASD*, 364 F.3d 908, 911-912 (8th Cir. 2004) ("the Exchange Act does not create a private right of action against the NASD defendants for violating their own rules" and a party's attempt to bypass the absence of a private right of action against NASD by asserting a claim under state contract law is "fruitless"); *Desiderio v. Nat'l Ass'n of Secs. Dealers, Inc.*, 191 F.3d 198, 208 (2d Cir. 1999) ("there is no private right of action available under the Securities Exchange Act . . . to challenge an exchange's failure to follow its own rules"), *cert. denied,* 531 U.S. 1069 (2001); *In re Olick*, 2000 U.S. Dist. LEXIS 4275, *11 (E.D. Pa. April 4, 2000) (a party "may not maintain a private cause of action against the NASD under the Exchange Act, or at common law, for regulatory actions taken by the NASD"); *Meyers v. NASD*, 1996 U.S. Dist. LEXIS 6044, *13 (E.D. Mich. March 29, 1996) (finding that "a majority of courts have held that there is no private cause of action against the NASD for a violation of its own rules") (citations omitted); *Feins v. AMEX*, 81 F.3d 1215 (2d Cir. 1996); *Pinnacle Security Investment Associates, L.P. v. AMEX*, 946 F. Supp. 290, 293-94 (S.D.N.Y. 1996).

In finding there is no private cause of action against SROs under the Exchange Act or for violations of rules enacted thereunder, courts have applied the analysis laid down by the United States Supreme Court for determining whether an implied right of action exists where the applicable statute does not expressly provide a private right of action. *See Shahmirzadi v. Smith Barney*, 636 F.Supp. 49, 51-52 (D. D.C. 1985). That test, which the Supreme Court developed in

a trilogy of cases, *Cort v. Ash*, 422 U.S. 66, 95 S.Ct. 2080 (1975), *Touche Ross & Co. v. Redington*, 442 U.S. 560, 99 S.Ct. 2479 (1979), and *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 100 S. Ct. 242 (1979), is "one of statutory construction." *Touche Ross*, 442 U.S. at 568. Instead, under the comprehensive regulatory scheme for the securities industry established by Congress, FINRA's performances of its responsibilities is subject to the strict, on-going oversight of the SEC. *See, e.g.*, 15 U.S.C. § 78o-3, *et seq.*, § 78s.

In this case, Plaintiffs seek civil court injunctive relief from FINRA's regulatory acts – specifically to enjoin the ongoing FINRA enforcement proceedings. Further, Plaintiffs seek approximately $3,000,000 in damages against FINRA. *See* Complaint, Relief ¶4 (p.29). But as demonstrated by the case law, there is no private right of action against FINRA for its regulatory acts - including FINRA's decisions to bring disciplinary proceedings and its prosecution of those disciplinary cases. Because there is no private right of action against FINRA for its regulatory acts, the entire Complaint against FINRA must be dismissed. Allowing this case to continue against FINRA would be contrary to Congressional intent, as evinced by the absence of a cause of action under the Exchange Act, and would be inconsistent with well-established precedent.

E. <u>Plaintiffs Fail To State A Claim of Negligent Spoliation Against FINRA</u>

To prevail on a negligent spoliation claim, a plaintiff must establish all of these required elements:

> (1) [t]he existence of a potential civil action; (2) a legal or contractual duty to preserve evidence which is relevant to that action; (3) destruction of that evidence by the duty-bound defendant; (4) significant impairment in the ability to prove the potential action; (5) a proximate relationship between the impairment of the underlying suit and the unavailability of the destroyed evidence; (6) a significant possibility of success of the potential civil action if the evidence were available; and (7) damages adjusted for the estimated likelihood of success in the potential civil action.

Cook v. Children's National Medical Center, 810 F.Supp. 2d 151, 155 (D. D.C. 2011) (*citing Holmes v. Amerex Rent-A-Car*, 710 A.2d 846, 854 (D.C. 1998)); *see also Holmes v. Amerex Rent-A-Car*, 180 F.3d 294 (D.C. Cir. 1999). While this Court generally recognizes the tort of negligent spoliation, it only does so when raised against a "third party." *See Cook,* 810 F.Supp.2d at 157. In *Cook*, the plaintiff alleged a negligent spoliation claim against an entity she was also suing in a malpractice case. In granting the defendant's motion to dismiss, the *Cook* court found that plaintiff "failed sufficiently to allege the first element under Homes: the existence of a potential civil action in which CNMC, the alleged spoliator, is not a party." *Id.* at 159 (*citing Holmes, supra*, 710 A.2d at 848, 854). In the present case, there can be no negligent spoliation claim against FINRA because it is the Complainant in the FINRA disciplinary cases and a defendant in this case and thus is not a "third party" under the *Cook* and *Holmes* cases. Thus, Plaintiffs have failed to meet the first required element of a negligent spoliation claim.

The Complaint also fails to establish the second required element of a negligent spoliation claim – that FINRA had a duty to preserve evidence relevant to the civil action. The crux of the negligent spoliation claim against FINRA is that it somehow "contributed to" the spoliation of emails maintained by Smarsh solely because FINRA requested those emails "in a "special format", e.g. ".pst." Complaint, ¶34. Specifically, the Complaint alleges "Enforcement also had a duty to avoid spoliation to ESI, however, by and through its agents and employees, FINRA negligently contributed to the spoliation during the examination and investigations of Southridge and Ocean Cross by requiring that electronic communications be converted and delivered in .pst format, non-native to Bloomberg communications and certain other email programs." Complaint, ¶92. Not only does this paragraph seem to plead the nonexistent tort of "contribution to spoliation", but on its face fails as FINRA had no duty to request emails in

native format. FINRA did not own, maintain, or control these emails. As a regulator, FINRA made a routine request to the firms' email vendor to obtain emails in .pst file format.

Requesting emails in ".pst" format is far from "special" as Plaintiffs contend – rather, it is usual and customary: "Email is not typically produced in native file format because the extraction of individual emails from a large database containing other emails requires conversion of the file format into a near-native format." 1-37A Moore's Federal Practice – Civil § 37A.43(1) (3d ed. 2015). "Collections of entire sets of emails, often stored in networked servers, can be extracted in a PST or NSF format, i.e., file extensions.pst or .nsf." *Id.* at § 37A.43(2). Like FINRA, the SEC also often requests emails in .pst file format. *See* Division of Enforcement, Enforcement Manual, §3.2.6.2.3 ("Format for Electronic Production of Documents to the SEC") specifically provides that SEC staff may accept emails in .pst file format.[10] FINRA owed no duty to Plaintiffs to request data from their firms' email vendor in a native file format. Even if the allegations of the Complaint could be considered, Plaintiffs' negligent spoliation claim against FINRA is so untenable that it fails as a matter of law.

[10] The SEC Enforcement Manual is publically available online at http://www.sec.gov/divisions/enforce/enforcementmanual.pdf. As a courtesy, a copy of the referenced section is attached as Exhibit 4.

IV. CONCLUSION

For all of the reasons set forth above, FINRA respectfully requests that the Court deny all injunctive relief and dismiss the Complaint as to FINRA with prejudice.

Dated: April 29, 2015

Respectfully submitted,

By: /s/ Terri L. Reicher

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CERTIFICATE OF SERVICE

This is to certify that, on April 29, 2015, Defendant Financial Industry Regulatory Authority, Inc.'s Motion to Dismiss, Memorandum in Support of its Motion to Dismiss, and attached Exhibits were served via electronic filing. All parties received notice via this electronic filing.

/s/ Terri L. Reicher
Terri L. Reicher