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NEWPORT COAST SECURITIES, INC.

UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

In the Matter of the Application of NEWPORT COAST SECURITIES, INC., DOUGLAS A. LEONE, AND ANDRE V. LABARBERA For Review of Disciplinary Action Taken by FINRA	**REPLY BRIEF OF APPLICANT NEWPORT COAST SECURITIES, INC.** **Admin. Proc. File No. 3-18555**

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INTRODUCTION

In expelling Newport, FINRA has entirely exceeded its authority under the Securities and Exchange Act of 1934 (the "Exchange Act"). The Exchange Act does not permit FINRA to impose a punitive sanction. It does not permit FINRA to impose a sanction that is "excessive, oppressive, or punitive." The Exchange Act also does not permit FINRA to place a burden on competition. But FINRA, in expelling Newport, has improperly done all of those things.

The sanction of expulsion imposed against Newport and its affiliated registered representatives was unwarranted, excessive, and oppressive given its punitive purpose. The NAC Decision effectively dismisses Newport's argument against its expulsion by concluding that its expulsion serves the remedial purpose of protecting the investing public. Equally important, FINRA failed to show how the NAC Decision serves the best interest of the investing public where the individuals primarily responsible to the wrongdoing were already expelled from the industry or settled with FINRA and allowed to stay in the industry. Newport, on the other hand, had already filed a Uniform Request for Broker-Dealer Withdrawal ("Form BDW"), to terminate its registration with the Commission, all SROs and all jurisdictions. Yet still, FINRA unjustifiably elected to issue the most severe sanction against Newport which the NAC confirmed. FINRA's goal of "investor protection" is just a thinly veiled excuse to punish an already out of business firm and every person who ever worked there.

The NAC Decision creates an unnecessary and severe burden on competition by permanently marking the record of Newport's former employees and limiting their ability to work at other member firms. Newport's former registered representatives are permanently associated with the conduct of a few rogue brokers, in spite of their lack of involvement in the underlying wrongdoing. Newport's expulsion has an impermissibly punitive effect on Newport's former employees and serves no remedial effect.

Moreover, the enforcement process at FINRA is unconstitutional, biased and rigged. A simple review of the last five years of NAC decisions shows that the NAC affirms the sanctions of the Office of Hearing Officers just about 100% of the time (from time to time, the NAC increases the sanctions). While this shrieks and screams of due process violations of the highest

magnitude, FINRA continues to act with impunity.

FINRA's tired argument that it has neither the liability of a private actor ("we have governmental immunity") nor the responsibilities of a government actor ("we are a private actor") fails under common sense, the Exchange Act and *Lucia*.[1] The enforcement action and NAC appeal to which Newport was subjected was unconstitutional and thus is void.

Under the Exchange Act, the United States Congress enacted a law that permitted the establishment by the United States Government of self-regulatory organizations ("SRO"), under 15 U.S.C. § 78s, Registration, responsibilities, and oversight of self-regulatory organizations. It is simply false that FINRA was not created by statute, as many courts have erroneously held in wrongly determining with little to no analysis that FINRA is not a "state actor" and that thus it can exercise unbridled power with no constitutional constraints.

Under the Exchange Act, the United States Securities and Exchange Commission (the "Commission") is empowered to delegate its regulatory authority over the buying and selling of securities to an SRO. An SRO cannot exist without applying for registration with the Commission, and, having the Commission, by order, grant such registration. Thus, the Commission delegates its power. Somehow, however, the delegation of the constraints and responsibilities on the delegated power got waylaid.

The SRO also may not enact any rules that are not approved by the Commission. The proposed rules even have to be published in the Federal Register and left open for comment.

However, the securities industry finds itself in the wholly untenable position that while the rules must be approved by the Commission, the *enforcement* of those rules is left to a regulator effectively answerable to no one and guided and constrained by nothing.

While FINRA contends it is not a state actor because it is merely "regulated by the government," in fact, it is acting with governmental authority granted to it by Congress under the Exchange Act. The very rules that FINRA is empowered by the Exchange Act to enforce are in the Exchange Act, such as "to prevent fraudulent and manipulative acts and practices." In 15

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[1] *Lucia, et al. v. SEC*, 138 S. Ct. 2044 (June 21, 2018).

U.S.C. § 78o-3(b)(6), FINRA is given the power, and delegated the responsibility, to regulate and enforce the federal securities laws, including such provisions as 15 U.S.C. § 78j and 17 C.F.R. 240.10b-5. In enforcing the FINRA rules, and in particular in conducting disciplinary proceedings, it has crossed the line from simply being a regulated entity to being a regulator of the buying and selling of securities.

In enforcing its rules (that the government enacts), FINRA is doing the same thing as the Commission, regulating the securities industry. *Lucia* is exactly on point.[2] FINRA Hearing Officers and NAC Panel Members exercise judicial powers that are normally reserved only for government actors. They rule on the admissibility of evidence, they have a subpoena power, they issue final decisions, etc.

FINRA is government-created by the Exchange Act. FINRA has expansive powers to regulate an entire industry, every single securities transaction in the United States. All firms and individuals who transact in securities must register with FINRA, pay it an annual fee and comply with its rules and oversight. FINRA regulates every detail of member firms' and associated persons' practices. FINRA performs audits and inspections, demands documents and testimony, and initiates formal investigations and disciplinary proceedings. Constitutional constraints must apply to FINRA.

Because it is not relevant to the issues on this appeal, Newport does not deny the factual findings made during the OHO hearing and later confirmed in the NAC Decision regarding its supervision of the named respondents. FINRA's thirty plus page recitation of the facts surrounding issues that were already conceded does nothing to further the gravamen of this appeal which is the constitutionality of FINRA's enforcement proceedings and the NAC Decision and FINRA's having exceeded its powers. The sole purpose is to inflame and prejudice.

Newport has properly raised each of the underlying issues brought before the Commission in its appeal to the NAC and its Opening Brief. In spite of that, the Supreme Court and Courts of Appeal have established that considerable discretion is given to the reviewing

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[2] *Id.*

court when considering arguments raised for the first time. Further, the Commission, as with any reviewing body, is well within it purview to determine caselaw that is unsettled prior to filing of the appeal- particularly when that law is central to the fundamental rights afforded under the Constitution and the issue at hand. *Lucia*[3] was not even decided until June 2018. Clearly Newport could not waive their arguments that a Supreme Court opinion that had not been issued yet applied to them.

ARGUMENT

I. NEWPORT DID NOT WAIVE THEIR ARGUMENT OF PREJUDICIAL TREATMENT BY FINRA AND IS NOT ESTOPPED FROM ITS RELIANCE ON LUCIA

The United States Supreme Court's opinion in *Lucia, et al. v. SEC,* [4] is entirely dispositive of the question of whether the enforcement proceedings against Newport were unconstitutional and void. They were. The decision was not handed down until June 2018, and FINRA's argument that reliance on it was waived is specious.

Newport raised the issues FINRA deems waived during its appeal to the NAC, and the Supreme Court '[a]nnounced no general rule' on whether a reviewing court can consider an argument raised for the first time, instead leaving it 'primarily to the discretion of the courts of appeals, to be exercised on the facts of the individual cases.[5] Equally consistent with that general principle, many courts of appeal have reached such arguments.[6]

Newport has always maintained that it, like other smaller firms, has been unfairly singled out and disproportionately punished for matters that are less egregious and systemic than at larger firms. Newport argued there is a clear divide between FINRA regulation of "large, old-line, rich broker-dealers and smaller, independent broker-dealers like Newport who cannot just write a million dollar check." Unlike many of Newport's contemporaries that are much larger in terms of net capital, it was unable to agree to settlement terms with FINRA and resolve this

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[3] *Id.*
[4] *Id.*
[5] *Singleton v. Wulff*, 428 U.S. 106, 121 (1976)
[6] *New York Life Ins. Co. v. Brown*, 84 F.3d 137, 143 (1996)

matter. Although, it should be recognized that Newport made a good faith attempt before it was forced to litigate and accept its fate. Meanwhile, payment of a hefty fine absolves a larger firm of even the most egregious conduct or the fatal consequence of license revocation.

In *Blinder, Robinson & Co. v. SEC*, the United States Court of Appeal for the District of Columbia considered a petitioner's claim that the SEC systematically imposed harsher sanctions on smaller firms.[7] The Court recognized that warning signs existed and that more than mere disparities were alleged.[8] It acknowledged that consideration must be given to whether or not a systemic pattern of disparate treatment, resulting in disproportionately harsh sanctions on smaller firms existed.[9] Similarly, Newport raised those same arguments in its appeal.

More significantly, Newport should not be precluded from relying legal precedent that was unsettled during the time of the underlying Enforcement hearing in 2017. Now, with the emergence of *Lucia*[10], the Commission has a clear guide on the proper appointment of OHO and NAC hearing officers with respect to FINRA Enforcement proceedings. FINRA's argument that Newport received fair notice of the charges against it, was able to present evidence at a hearing and, among other things, had the ability to object to the appointment of panelist misses the point. As stated below, the fact that the OHO and NAC officers were not appointed by the "President, 'Courts of Law,' or 'Heads of Departments,'" invalidates Newport's entire administrative proceedings.[11] Newport's overall position is FINRA's Enforcement process was unconstitutional.

II. FINRA IS A STATE ACTOR AND NEWPORT AND ITS FORMER EMPLOYEES ARE ENTITLED TO THE CONSTITUTIONAL PROTECTIONS

Constitutional claims against a private entity are only valid if the entity is properly considered a state actor under the doctrine.[12] ("[W]e consider the burden of demonstrating joint activities sufficient to render NASD a state actor to be high . . . ."). The state action doctrine

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[7] *Blinder, Robinson & Co. v. SEC*, 837 F.2d 1099 (1988)
[8] *Id.*
[9] *Id.*
[10] *Lucia, supra note 1.*
[11] *Id. at 2050.*
[12] *See, e.g.*, Frank P. Quattrone, Exchange Act Release No. 53547, 87 SEC Docket 1847, at 11 (Mar. 24, 2006).

embodies the fundamental principle that the Constitution only regulates government conduct. When evaluating a state action question the relevant conduct is analyzed under one of the following theories: (1) the public function test; (2) the state compulsion test; (3) the symbiotic relationship or nexus test; and (4) the entwinement test.[13]

A. FINRA WAS DELEGATED A TRADITIONALLY PUBLIC FUNCTION

When a private actor is delegated a traditional public function, the private actor is treated as a state actor for purposes of the Constitution and laws of the United States: "Under the public function test, when private individuals or groups are endowed by the State with powers or functions governmental in nature, they become agencies or instrumentalities of the State and subject to its constitutional limitations. To satisfy the public function test, the function at issue must be both traditionally and exclusively governmental."[14] This is well settled: In *Evans*, a private party who was delegated the task of managing and operating a public park was held to be a state actor; in *Marsh*, the proprietors of a privately owned "company town" were held to be state actors; and in *Terry*, and *Smith*, political parties that conducted outcome-determinative elections were held to be state actors.[15]

FINRA is the paradigmatic example of a state actor under the public function test. It has been delegated regulatory authority that would otherwise be exercised by the SEC or some other arm of the executive branch of the federal government.[16] Any changes to FINRA's rules must be approved by the government.[17] It acts as investigator, prosecutor, and adjudicator, just like an administrative agency. Moreover, it claims the immunities of a prosecutor or sovereign. FINRA should not be permitted to pick and choose a public or private identity based on whatever legal theory allows it to avoid legal accountability. The definition at issue defines "agency" as

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[13] *Vistein v. Am. Registry of Radiologic Technologists*, 342 Fed. Appx. 113, 127 (2009) (citing *Wolotsky v. Huhn*, 960 F.2d 1331, 1335 (1992); *see also, Brentwood Acad. v. Tenn. Secondary Sch. Ath. Ass'n*, 531 U.S. 288, 298 (2001)

[14] *Lee v. Katz*, 276 F.3d 550, 554-55 (2002).

[15] *Evans v. Newton*, 382 U.S. 296, 302 (1966); *Marsh v. Alabama*, 326 U.S. 501 (1946); *Terry v. Adams*, 345 U.S. 461 (1953); *Smith v. Allwright*, 321 U.S. 649 (1944).

[16] S. Rep. No. 94-75, 94th Cong. 1st Sess., 1975 WL 12347, at *23 (SROs are "delegated governmental power in order to enforce, at their own initiative, compliance by members of the industry with both the legal requirements laid down in the Exchange Act and ethical standards going beyond those requirements") (emphasis added).

[17] 15 U.S.C. § 78s(b).

including "any independent regulatory agency." FINRA is clearly an independent regulatory agency under that definition; indeed, that statutory language seems tailor-made to apply to FINRA. FINRA exercises regulatory power and performs a governmental function, but does so independently of direct control by the executive branch. FINRA meets the public function test.

B. FINRA IS A WILLFUL PARTICIPANT IN JOINT ACTIVITY AND ENTWINED WITH GOVERNMENTAL POLICIES

More recently, the Court's landmark decision in *Brentwood Academy v. Tennessee Secondary School Athletic Association,* overruled the Court's previous decision in *National Collegiate Athletic Association v. Tarkanian.* [18] The issue before the *Brentwood* Court was "whether a statewide association incorporated [under Tennessee's State Board of Education] to regulate interscholastic athletic competition among public and private secondary schools may be regarded as engaging in state action when it enforces a rule against a member school [Brentwood Academy]."[19] The Court found: (i) that the Association's public entwinement with the state was established by the Tennessee State Board of Education's adoption of "a rule expressly 'designat[ing]' the Association as 'the organization to supervise and regulate the athletic activities in which the public junior and senior high schools in Tennessee participate on an interscholastic basis'"; (ii) that the rule allowed the State Board to retain its supervisory role over the Association's self-regulatory activities, through its reservation of the right "to approve[] the Association's rules and regulations ... [and] ... the right to review future changes"; and (iii) that the physical makeup of the Association revealed that a majority of its membership "was comprised of public schools, controlling eighty-four percent of the total membership, while independent and parochial schools make up the remainder."[20]

After these findings the *Brentwood* Court held that the Association's regulatory activity should be "treated as state action owing to the pervasive entwinement of state action officials in

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[18] *Brentwood Acad. v. Tenn. Secondary Sch. Ath. Ass'n,* 531 U.S. 288 (2001); *see also, Nat'l Collegiate Ath. Ass'n v. Tarkanian*, 488 U.S. 179 (1988)

[19] *Id.*
[20] *Id.*

the structure of the association."[21] The Court cited *Lebron v. Nat'l R.R. Passenger Corp.* and *Evans v. Newton* as support for its holding.[22] In *Lebron*, the Court held that when "the Government creates a corporation by special law, for the furtherance of Governmental objectives, and retains for itself permanent authority to appoint a majority of the directors of that corporation, the corporation is part of the Government for purposes of the First Amendment."[23] In *Evans*, the Court held that "[c]onduct that is formally 'private' may become so entwined with governmental policies or so impregnated with a government character as to become subject to the constitutional limitations placed upon state action."[24]

The *Brentwood* Court elaborated on entwinement thusly: "Our cases have identified a host of factors that can bear on the fairness of such an attribution. We have, for example, held that a challenged activity may be state action when it results from the State's exercise of coercive power... when the State provides significant encouragement, either overt or covert... or when a private actor operates as a willful participant in a joint activity with the state or its agents... We have treated a nominally private entity as a state actor when it is controlled by an agency of the State... when it has been delegated a public function by the State... when it is entwined with governmental policies, or when government is entwined in [the private entity's] management or control."[25] By concluding that the Association, overborne by its public entwinement with the state, was to be charged with a public character and adjudged by constitutional standards, the Court essentially overruled its prior decision in *National Collegiate Athletic Association,* and broadened the application of the Constitution's protections in the private community.[26]

The judicial branch has swept aside the concept of a completely non-governmental private entity with regard to the SROs by labeling them quasi-governmental entities. Courts have acknowledged the government's pervasive entwinement in the regulatory affairs of the SROs, characterizing the government as something akin to either a regulatory partner or control person

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[21] *Id.*
[22] *Lebron v. Nat'l R.R. Passenger Corp.*, 513 U.S. 374 (1995); *see also, Evans v. Newton*, 382 U.S. 296 (1966).
[23] 513 U.S. § 400; *see also, Lebron, supra note 19.*
[24] *Evans, supra note 19.*
[25] *Brentwood, supra 15.*
[26] *National Collegiate Athletic Association supra 15.*

of the SROs.[27] Moreover, the courts have strengthened this agency argument by determining the SROs' impregnation with government immunity to be constitutional. Despite the government's extensive supervision of the SROs' regulatory activities, and the SROs' impregnation with certain notable government features, the earlier courts have concluded that there is an insufficient nexus between the state and SROs to convert the latter organization into state actors. The Supreme Court's decision in *Brentwood*[28] Academy, however, appears to have opened the door to a judicial reclassification of the SROs as state actors. In its decision, the *Brentwood*[29] Court set forth a fourth approach to the state action doctrine, entitled the public entwinement theory, which explicitly provided that a private enterprise overborne by its public entwinement with the state should be charged with a public character and adjudged by constitutional standards.

The conduct of FINRA also meets state action under the entwinement test. FINRA satisfies the requirements of this test because it is clearly "entwined with governmental policies" and the government is "entwined in [FINRA's] management or control."[30] FINRA and the federal government are not merely cooperating – their "entwinement" rises to "the level of merger required for a state action."[31] Further, "[t]he crucial inquiry under the entwinement test is whether the 'nominally private character' of the private entity 'is overborne by the pervasive entwinement of public institutions and public officials in its composition and workings [such that] there is no substantial reason to claim unfairness in applying constitutional standards to it.'"[32]

There is no reason to claim unfairness in applying Constitutional standards to FINRA, an organization that has the authority, like the SEC, to fine, suspend or bar brokers from the industry altogether. Equally significant, FINRA too may initiate dispositive investigations from a variety of sources, including examination findings, filings, complaints, among other things. In

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[27] *Brentwood, supra 15.*
[28] *Brentwood, supra 15.*
[29] *Id.*
[30] *Vistein v. Am. Registry of Radiologic Technologists*, 342 Fed. Appx. 113, 127 (2009) (quoting Brentwood, 531 U.S. at 296)
[31] *Lansing v. City of Memphis*, 202 F.3d 821 (2002).
[32] *Vistein, supra 27.*

the instant matter, FINRA's Enforcement proceedings and the NAC's affirmation of the OHO's imposition of the ultimate sanction of expulsion to be enforced by the SEC are clear markers of a pervasive entwinement with government and the composition and workings of public entities. One can hardly claim unfairness in applying due process or constitutional standards to such a powerful entity, particularly when no alternative remedies or regulators are available to broker-dealers.

The "entwinement" analysis is illuminated by the analysis in *Lucia*, particularly as SROs are "delegated governmental power in order to enforce, at their own initiative, compliance by members of the industry with both the legal requirements laid down in the Exchange Act and ethical standards going beyond those requirements").[33] Any changes to FINRA's rules must be approved by the government.[34] It acts as investigator, prosecutor, and adjudicator, just like the SEC. And it claims the immunities of a prosecutor or sovereign. FINRA should not be permitted to pick and choose a public or private identity based on whatever legal theory allows it to avoid legal accountability.

The Special Trial Judges (STJs) of the U.S. Tax Court in *Freytag* were deemed to be "near-carbon copies of the [Securities Exchange] Commission's [Administrative Law Judges] ALJs."[35] The *Freytag* Court held that the STJs were officers, not mere employees, because they held a continuing office established by law, served on an ongoing, rather than temporary or episodic basis, and their duties, salary, and means of appointment were all specified in tax code.[36] Significantly, the ALJs and the STJs both have the power to enforce compliance with discovery orders, and may punish all "contemptuous conduct, including violations of those orders, by means as severe as excluding the offender from the hearing.[37] STJS and SLJs issue decisions, prepare proposed findings and an opinion, adjudicating charges and assessing liabilities. The OHO and NAC officers exercise nearly identical authority, presiding over

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[33] *Lucia, supra note 1.*
[34] 15 U.S.C. § 78s(b).
[35] *Lucia, supra note 1; see also, Freytag v. Commissioner,* 501 U.S. 868 (1991).
[36] *Id.*
[37] *Id.*

adversarial enforcement proceedings and deciding the rights of participants. In the instant matter, OHO hearing officers conducted an administrative proceeding, filed a Complaint against Newport, required the introduction of evidence and testimony, and ruled on admissibility. This is clearly an exercise of significant discretion, and mirrors the applicable factors and analysis deployed by both the *Freytag* and *Lucia* Courts: "The SEC has statutory authority to enforce the nation's securities laws.[38] One way it can do so is by instituting an administrative proceeding against an alleged wrongdoer. By law, the Commission may itself preside over such a proceeding.[39] But the Commission also may, and typically does, delegate that task to an ALJ."

An ALJ assigned to hear an SEC enforcement action has extensive powers—the "authority to do all things necessary and appropriate to discharge his or her duties" and ensure a "fair and orderly" adversarial proceeding.[40] Those powers "include, but are not limited to," supervising discovery; issuing, revoking, or modifying subpoenas; deciding motions; ruling on the admissibility of evidence; administering oaths; hearing and examining witnesses; generally "[r]egulating the course of" the proceeding and the "conduct of the parties and their counsel"; and imposing sanctions for "[c]ontemptuous conduct" or violations of procedural requirements.[41]

Just as the ALJs were deemed to be state actors on par with the STJs, so too should the OHO and NAC hearing officers be deemed to be state actors. The hearing on Enforcement's Complaint filed against Newport Coast Securities took place before the OHO hearing panel, during which the panel heard testimony from thirty-two witnesses named in the Complaint. The OHO hearing panel admitted numerous documents and exhibits into evidence. The OHO hearing panel issued a decision shortly thereafter, holding that the respondents had violated federal securities laws, as well as NASD and FINRA rules. Based on these findings the OHO hearing panel determined that the alleged violations were so closely interrelated as to justify the ultimate sanction of expulsion. Moreover, the expulsion had the additional effect of subjecting former Newport Securities, Inc. employees to FINRA Rule 3170, or the "Taping Rule."

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[38] *Lucia v. SEC,* 138 S. Ct. 2044 (2018); *see also,*15 U.S.C. § 78d–1(a).
[39] 17 C.F.R. § 201.110 (2017).
[40] SEC § 201.111; *see also, SEC* § 200.14(a)
[41] *Lucia, supra note 35.*

The NAC concluded that subjecting former employees to the Taping Rule was not a sanction, or a restriction on their access to services or association with other firms. This determination is clearly erroneous, as these former employees' right to free association is significantly and permanently restrained. Moreover, this restraint has been applied to persons who were not subject to the original Complaint brought by Enforcement.

The findings, rulings, and sanctions bestowed by NAC do not merely align with the authority exercised by the ALJs and the STJs. The NAC's adjudicatory power in this regard surpasses that of the STJs and the ALJs. After a hearing ends an ALJ issues an initial decision, which sets out findings and conclusions about material issues of act and law, and includes an appropriate order, sanction, relief, or denial thereof."[42] However, the SEC can then review the ALJ's decision, either upon request or sua sponte. Id. If the Commission opts against review, its initial decision is deemed the final action of the Commission. Id. It is the finality of this decision that makes an ALJ a state actor with "significant authority."[43]

In *Freytag*, the Government argued that STJs are employees rather than officers because they could not enter a final decision.[44] The Court did not follow this line of thought, reasoning that the Government's focus on finality ignored the significance of the duties and discretion that STJs possess. However, even if we applied this heightened standard to FINRA, we cannot help but draw the same conclusion as the Government did in *Freytag*.[45] The NAC possesses "significant authority" because it is able to make a decision regarding the rights of a private actor, and that decision is not reviewable. There is no mechanism by which the Taping Rule can be reviewed or overturned. A broker-dealer or associated person is subject to Taping Rule has no recourse. Therefore, NAC clearly possesses significant authority, for exceeding beyond that held by the STJs and ALJs. Such authority makes FINRA a state actor.

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[42] *Lucia v. SEC,* 138 S. Ct. 2044 (2018);*also see,* USC § 201.360(b).
[43] *Buckley v. Valeo*, 424 U.S. 1 (1976)
[44] *Freytag, supra 32.*
[45] *Id.*

III. THE EXPULSION OF NEWPORT IS EXCESSIVE, OPPRESSIVE, AND PUNITIVE, AND MUST BE RESCHEDULED

The capital punishment of expulsion in this matter is entirely punitive, as there are no remedial justifications to support it. Expulsion of Newport flies in the face of the intent behind the Guidelines, which only permits remedial sanctions as opposed to punitive ones. FINRA expelled a firm that was already out of business, which serves no purpose at all, and exceeds FINRA's remedial powers. In fact, all it does is tar the hundreds of innocent representatives who were formerly associated with Newport with the scarlet letter of being "from an expelled firm."

The FINRA Sanctions Guidelines provide that disciplinary sanctions are not allowed to be punitive, but only remedial to deter future misconduct and to improve overall standards in the securities industry. In reviewing the sanction imposed by an SRO upon a member firm, a regulatory agency may "cancel, reduce, or require the remission: of a sanction "that .... is excessive or oppressive..."

Here, FINRA has failed to establish any remedial purpose that expulsion would effectuate in this matter. FINRA claims several aggravating factors support its decision to expel Newport, and ultimately expulsion was implemented because "Newport's history evidences that the firm poses a risk to the investing public." However, a firm that is out of business poses absolutely no risk to the investing public.

While Newport had eleven regulatory disclosures (including most recently, failure to comply with an arbitration award, failure to pay fees, and submission of reports with improperly formatted data), big firms have hundreds of regulatory disclosures and FINRA would never expel them. For instance, JP Morgan Securities LLC has 328 regulatory events. Citigroup Global Markets has 522 regulatory disclosures. Even the venerated Goldman Sachs & Co LLC has 317 regulatory disclosures. Yet, none of these firms would ever even be threatened with the capital punishment of expulsion.

Moreover, it cannot be overstated that expulsion of a firm is capital punishment, death to a firm. It is also a sanction and punishment that FINRA reserves nearly exclusively for small firms. The big firms, most of which have hundreds of disclosures, simply pay a fine no matter

how egregious the conduct. The large firms crashed the entire global economy and instead of putting them out of business, the government bailed them out, as "too big to fail." Newport had five representatives with actively traded accounts and, even though Newport already filed Form BDW, FINRA decides to tar the firm, and the hundreds of former representatives and employees, with the scarlet letter of being from an expelled firm.

And, what FINRA fails to account for is that the select individuals responsible for the misconduct were also barred, or settled with FINRA and allowed to continue in the business. How can FINRA explain the fact that the two direct line supervisors were only suspended but somehow an entire firm has to be expelled?

Out of business, Newport no longer posed any risk to the investing public. Moreover, there is no need to protect the public from the former Newport representatives who were innocent, uninvolved, and had no such record of malfeasance.

The sanction of expulsion, while doing nothing to the member firm or to remediate, harshly punishes the innocent representatives who used to work there.

Nothing could be more oppressive, punitive, and pointless than expelling a firm that is already out of business. It entirely exceeds FINRA's authority to do so.

IV. THE EXPULSION OF NEWPORT IMPOSES A SEVERE UNDUE BURDEN ON COMPETITION AND MUST BE CANCELLED

Expelling Newport only has one effect; that is, to impose severe burdens on competition of representatives who formerly worked at Newport and the member firms who hire them. The SEC has the power to overturn the expulsion sanction because it is neither necessary nor appropriate. A regulatory agency may "cancel, reduce, or require the remission: of a sanction "that imposes any burden on competition not necessary or appropriate in furtherance of the purposes of [15 U.S.C. § 78a et seq.] or is excessive or oppressive..."[46] Newport maintains that not only is expulsion excessive and oppressive, but it also poses a severe undue burden on competition for former affiliates of Newport, as well as employers of former Newport affiliates.

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[46] 15 U.S.C. § 78a

FINRA argues that any burden on competition is outweighed by the necessity for protecting the public interest. The question that FINRA cannot answer is what they are claiming to be trying to protect the public interest from? A firm that is out of business for wholly unrelated reasons prior to expulsion? From innocent representatives who had nothing to do with what was issue in the enforcement action and have clean records? From innocent member firms who hire innocent representatives who just want to make a living?

The balancing test presupposes that the sanctions imposed are at least moderately tailored to advance the public interest. In the case at bar, the obvious public interest is protecting investors from brokers and advisers who repeatedly engage in misconduct. Individuals at Newport were charged with unsuitable and excessive trading and churning, and failing to supervise its representatives. The individuals responsible have already been permanently barred from the profession or have settled with FINRA and have been allowed to continue in the profession (as have many, many other brokers and member firms who have done that or worse but who have come up with the money to settle with FINRA). Expelling Newport, after it had already filed Form BDW, never served any public interest upon which the sanction is premised.

Rather than protect the public interest, expelling Newport only serves to severely burden competition. Instead, every single broker who ever worked at Newport will now permanently have on his public record on Brokercheck a red triangle with an exclamation point in it, indicating that they worked "for an expelled firm," casting them automatically in a suspicious light.

The mark on Brokercheck is permanent and clients and potential clients will see it for the next twenty years and beyond. If a broker works at Newport for merely a month, that mark will remain on their Brokercheck for the rest of their career. This will severely impact the representatives from getting and keeping clients and even simply obtaining employment.

The severe burden on competition also extends to the member firms who hire brokers who formerly worked at Newport, other small broker-dealers. Having brokers from an "expelled firm" is seen as a negative even if those brokers have clean records and had nothing at all to do with any alleged wrongdoing. Hiring firms get unfairly tarnished. The innocent brokers deserve

a place to work and earn a living to support their families and the hiring firms do not deserve to be unfairly tarnished.

It is thus critical that this burden on competition be seen to heavily outweigh expelling a broker-dealer that was already out of business (which in any event FINRA lacks the power to do because it is punitive and not remedial). Expelling a firm is not to be taken lightly or blithely. It is a severe sanction, with far, far reaching implications.

In arguing the contrary, FINRA relies upon three cases, *Wedbush, Exchange Services, Inc. and James Lee Goldberg.*[47] However, the factual circumstances arising from these cases are in stark contrast with the case at bar.

In *Wedbush*, FINRA fined Wedbush Securities ("Wedbush"), the firm, as well as its president, Edward Wedbush, and also suspended Mr. Wedbush for 31 days, for having committed 158 violations of the rules and bylaws of NASD, NYSE and FINRA by failing to file, filing late, and filing inaccurate forms and reports. There were also allegations of failure to supervise regulatory findings. *Wedbush* argued that the suspension would impose an unnecessary and inappropriate burden on competition, in that it treated him differently from the "principals at the 'big dogs' of Wall Street." The Commission rejected this argument, holding that the record did not show that FINRA engaged in favorable treatment to others, and further that there would be no unnecessary or inappropriate burden.

The facts in *Wedbush* cannot be seriously compared to that of the present case. *Wedbush* was sanctioned with a brief suspension, and otherwise set forth no facts which would indicate a severe burden. Newport, on the other hand, was sanctioned with a permanent expulsion, which will have deleterious effects on competition for its former affiliates, as well as the employers of former affiliates. Former employees will forever be branded on BrokerCheck, as having come from an expelled firm. This will undeniably spark doubt in an investor's mind when choosing a broker or adviser to handle their investments. It could be so discouraging to potential investors

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[47] *Wedbush Sec. Inc.*, Exchange Act Release No. 78568, 2016 SEC LEXIS 2794, at *60 n.88 (Aug. 12, 2016); *see also, Exchange Servs., Inc. v. SEC*, 797 F.2d 188, 191 (4th Cir. 1986); *see also, James Lee Goldberg*, Exchange Act Release No. 66549, 2012 SEC LEXIS 762, at *29 (Mar. 9, 2012).

that they might not even inquire as to the circumstances surrounding the expulsion. This leaves former employees little recourse to clear their name, and communicate to potential clients that they were uninvolved with the purported wrongdoing. Such a result is patently unfair and will haunt these professionals throughout their career.[48]

In *Exchange Servs., Inc.* and *James Lee Goldberg*, the Applicants sought a waiver to forgo certain qualification examinations.[49] In both these cases, the Applicants argued that they would suffer an undue burden on competition if not granted a waiver. The Commission rejected these arguments for similar reasons: that the public interest in ensuring [brokers, advisers, order takers, etc.] are competent to serve as investment banking representatives outweighs any purported burden on competition. In the present case, the public interest is ensuring investor protection, and preventing misconduct from continuing in the future. However, the objective of investor protection is not met by expelling Newport, because Newport had already filed Form BDW, and further, the responsible individuals had been permanently barred or settled with FINRA and allowed to remain in the industry. Thus, there remained no threat to the investing public.

In the cited cases, the sanctions were made with the public interest in mind, and sanctions were narrowly tailored to address prevention of further wrongdoing, and protection of the public. The sanctions rendered in the present case are gross overreaching and will negatively impact far more than it will deter unsavory conduct.

Finally, FINRA argues that if they did not expel Newport, Newport would be free to reinstate and begin its misconduct once again. FINRA simply cannot grant itself the power to punish, regardless of its specious hypotheticals.

Therefore, the objective intended by expulsion completely misses the mark, and should be cancelled.

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[48] *Id.*
[49] *Id.*

CONCLUSION

For all the forgoing reasons above and in Newport's Opening Brief, Newport respectfully submits that the NAC Decision should be reversed, and the sanction imposed against it vacated. In the alternated, the case should be remanded for a new hearing before a properly appointed panel.

Respectfully Submitted,

Dated: October 10, 2018

By: *s/John W. Stenson*
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JEANNINE V. STEPANIAN
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CERTIFICATE OF SERVICE

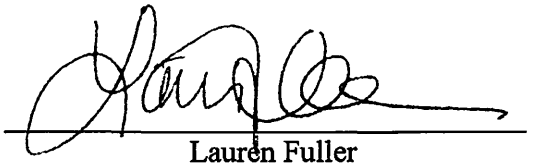
Pursuant to Rule 150 and Rule 151 of the Commission's Rules of Practice, I hereby certify that on **October 10, 2018**, I served true and correct copies of the foregoing documents described as the **REPLY BRIEF OF APPLICANT NEWPORT COAST SECURITIES, INC.** on the following parties and persons by placing a true copy thereof enclosed in a sealed envelope addressed as follows:

Office of the Secretary **[Original and 3 copies]**
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
Facsimile: (202) 772-9324

Jennifer Brooks, Esq.
Office of General Counsel
FINRA
1735 K Street, NW
Washington, D.C. 20006-1500
Facsimile: (202) 728-8264

☒ **BY MAIL**: By placing the document(s) listed above in a sealed envelope with postage thereon fully prepaid, in the United States mail at Los Angeles, California addressed as set forth above. I am readily familiar with the firm's practice of collection and processing of correspondence for mailing. Under that practice, it would be deposited with the U.S. Postal Service on that same day with postage thereon fully prepaid in the ordinary course of business. I am aware that on motion of the party served, service is presumed invalid if the postal cancellation date or postage meter date is more than one day after the date of deposit for mailing in this Declaration.

☒ **BY FACSIMILE**: I caused the above-referenced documents(s) to be transmitted to the above-named person(s) at the facsimile telephone number exhibited therewith. The facsimile machine I used complied with California Rules of Court, Rule 200 and the transmission was reported as complete and without error. Pursuant to California Rules of Court, Rule 2006 (d) I caused the machine to print a transmission record of the transmission and the transmission report was properly issued by the transmitting facsimile machine.



Lauren Fuller