SELF-REGULATION OF THE AMERICAN RETAIL SECURITIES MARKETS – AN OXYMORON FOR WHAT IS BEST FOR INVESTORS?

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> *For self-regulation to be effective, government must play a residual role, keeping a shotgun "behind the door, loaded, well-oiled, cleaned and ready for use but with the hope that it would never have to be used."*[1]
>
> - William O. Douglas, SEC Chairman

INTRODUCTION

In the fall of 1930, a mechanic from Houston wrote that in "[a] land flowing with milk and honey,"

> a "first-class mechanic can't make an honest living." Having lost his savings in the recent stock market crash and unable to find work in the shadow of the Great Depression, he was too proud to beg for money and "too honest to steal." In the end, he decided to take matters into his own hands, writing that he would "rather take [his] chances with a just God than with an unjust humanity."[2]

Eighty-one years later, the story is still much the same, and the need for investor protection for the American retail investing public is greater

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1. WILLIAM O. DOUGLAS, DEMOCRACY AND FINANCE 82 (Allen ed., 1940).
2. ANTHONY J. BADGER, THE NEW DEAL: THE DEPRESSION YEARS, 1933–1940 11 (2002).

than ever. On December 11, 2008, Richard Shapiro, a retired real estate developer, rose one morning expecting to quietly peruse the morning newspaper. Instead, his worst fears were starkly splashed across the front page. He felt the color drain from his face as he struggled to comprehend the dire headlines. Bernard Madoff, a trusted financial adviser, had been arrested after confessing to cheating investors out of billions of dollars.[3]

Mr. Shapiro reeled at the news. Upon retirement, he had invested the entirety of his savings with Madoff. In an instant, his financial security had vanished. Shapiro sunk into a deep depression and did not leave his home for twenty-three days. Too upset to eat, he lost thirty pounds. To make ends meet, he was forced to sell his home and abandon retirement. Despite these sacrifices, he still struggles to ensure his bills are paid. Shapiro has stated that he felt "violated" because regulators had acted like "co-conspirators" instead of protecting investors.[4]

When the federal government first ventured into securities regulation in the 1930s, it was in direct response to a cataclysmic event: the stock market crash of 1929 and the ensuing Great Depression. Although speculation was rampant leading up to the crash, the types of investments at the time were mostly limited to stocks and bonds. Eight decades later, the regulatory structure of the retail securities markets is relatively the same, yet the complexity of that market has grown exponentially. Investors may now purchase variable annuities, exchange-traded funds, options, foreign currency, and a seemingly unlimited number of exotic securities created by investment banks. Many of these complex investments, in particular credit default swaps and debt obligations collateralized by subprime mortgages, were instrumental in the global recession that began in 2008.

At the same time, some very public failures in the enforcement of American securities laws (in particular, the Madoff and Allen Stanford investment scandals) further eroded investor confidence in the securities markets and in the ability of regulators to regulate those markets. The Office of Inspector General's Investigative Report concerning Madoff is particularly damning. It found that the United States Securities & Exchange Commission ("SEC") had enough information to warrant an extensive investigation of Madoff as early as 1992.[5] Despite these warnings and incriminating evidence provided to regulators, neither the

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3. Amir Efrati, Tom Lauricella, & Dionne Searcey, *Top Broker Accused of $50 Billion Fraud*, WALL. ST. J., Dec. 15, 2008, at A14.

4. Letter from Richard Shapiro, Madoff Victim, to the Honorable Denny Chin, U.S. District Court, Southern District of New York (Mar. 10, 2009).

5. U.S. SEC OFFICE OF INVESTIGATIONS, REPORT NO. OIG-509, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME (PUBLIC VERSION) (2009), *available at* http://www.sec.gov/news/studies/2009/oig-509.pdf.

SEC nor the Financial Industry Regulatory Authority ("FINRA")—the self-regulatory organization ("SRO") for broker-dealers and their agents—responded to Madoff's Ponzi scheme until after he confessed in 2008.[6]

The recent economic crisis has garnered the attention of the United States Congress, the European Union, and regulators across the globe. Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") in 2010, touted as the most sweeping change to financial regulation since the Great Depression. Included in the Dodd-Frank Act is a requirement for the SEC to evaluate the adequacy of its oversight of investment advisers and to recommend whether Congress should designate one or more SROs to bolster the SEC's supervision.[7] FINRA, which is already the SRO for broker-dealers, has signaled its desire to be the SRO for investment advisers as well.[8] As of this writing, hearings have been held before the House Financial Services Committee on proposed legislation authorizing one or more SROs for investment advisers.[9]

Missing from the debate in the United States, however, is whether the SRO model of securities regulation is an appropriate part of the American regulatory framework in the first place, and if so, whether any changes need to be made in order to make the regulatory framework more efficient and effective. This Article explores the complicated history of self-regulation in the U.S. retail securities markets, and analyzes the current challenges in cooperation among the SEC, FINRA, and state securities regulators. Finally, a variety of normative solutions are offered to highlight opportunities to improve efficiency, reduce potential conflicts of interest, enhance communication, and limit costs.

I. THE DEVELOPMENT OF THE CURRENT REGULATORY STRUCTURE

The allure of profits inevitably engenders speculation and aggressive

6. *Id.* at 1. As a result of the SEC investigation, however, the SEC disciplined eight employees for missteps related to the Madoff investigation. *See* Jesse Hamilton, *SEC Suspended Employees, Cut Pay Over Madoff Missteps*, BLOOMBERG, Nov. 14, 2011, *available at* http://www.bloomberg.com/news/2011-11-11/sec-suspended-employees-reduced-pay-over-missteps-related-to-madoff-case.html.

7. Dodd-Frank Wall Street Reform and Consumer Protection Act § 914, 15 U.S.C. § 80b-11 (2012).

8. Richard G. Ketchum, Chairman & Chief Exec. Officer, Fin. Indus. Regulatory Auth., Speech at Securities Industry and Financial Markets Association Compliance and Legal Division's Annual Seminar (Mar. 22, 2011), *available at* http://www.finra.org/Newsroom/Speeches/Ketchum/P123371.

9. Hearing witnesses and written submissions can be found at the Committee on Financial Services' website at http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=258252.

trading practices. The 1929 stock market crash and the ensuing Depression are generally credited with inspiring federal securities regulation.[10] The long history of retail securities regulation in the United States, however, is far more nuanced.

A. Brokers "Exchange" Independence For Structure And Credibility

Wall Street experienced its first major crash in 1792.[11] In the wake of that crash, Pennsylvania and New York passed legislation intended to regulate the sales of securities.[12] New York aggressively disallowed open-air "public outcry" markets.[13] In response, brokers took control of their own destinies and began to associate together, planting the seeds of exchange-based trading and self-regulation in America.[14]

In May of 1792, twenty-four brokers congregated at 68 Wall Street.[15] They "pledged to deal primarily among themselves and to honor minimum commission rates."[16] Members of that group of brokers officially formed the New York Stock Exchange ("NYSE" or "the Exchange") on March 8, 1817.[17]

10. *A Brief History of Securities Regulation*, STATE OF WIS. DEP'T OF FIN. INSTS., http://www.wdfi.org/fi/securities/regexemp/history.htm (last visited June 2, 2012).

11. *The Institution of Experience: Self-Regulatory Organizations in the Securities Industry, 1792–2010,* SECS. & EXCH. COMM'N HISTORICAL SOC'Y, http://www.sechistorical.org/museum/galleries/sro/sro02a.php (last visited June 2, 2012).

12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.* Early American self-regulated exchanges followed the British tradition of private trading clubs of the times. *See id.* More recently, the United Kingdom's regulatory system for financial services had its roots in self-regulation within the Financial Services Authority ("FSA"), as created in October 1997. PEIJIE WANG, FINANCIAL ECONOMICS 308 (2d ed. 2009). For over a decade, the FSA served as a single independent organization that was responsible for overseeing the banking, brokerage, and insurance industries. However, recent weakness in global financial services has brought about the downfall of the FSA and self regulation. The FSA is set to be disbanded by 2012 in favor of government-controlled regulators. Shannon Hawthorne, *UK Chancellor announces abolition of FSA*, HFMWEEK (June 17, 2010), http://www.hfmweek.com/news/572177/uk-chancellor-announces-abolition-of-fsa.thtml.

16. *Buttonwood Agreement*, SEC HISTORICAL SOC'Y, http://sechistorical.org/collection/papers/1790/1792_0517_NYSEButtonwood.pdf.

17. *The Institution of Experience: Self-Regulatory Organizations in the Securities Industry*, SEC HISTORICAL SOC'Y, http://www.sechistorical.org/museum/galleries/sro/sro02a.php (last visited June 2, 2012) [hereinafter SEC HISTORICAL SOCIETY]. Juxtapose the time period for the creation of the NYSE with the more recent development of a non-state controlled securities market in China. The Shanghai Stock Exchange and the Shenzhen Stock Exchange were each founded in 1990. *Brief Introduction to the SEE*, SSE.COM.CN, http://www.sse.com.cn/sseportal/en_us/ps/about/bi.shtml (last visited June 2, 2012); *SZSE Major Event and Milestones from 1990–2011 (Condensed Version)*, SZSE.CN,

The NYSE was premised on seventeen rules that governed trading and provided for admission and discipline of members.[18] The NYSE envisioned a trading platform in which strenuous admission standards would make sanctions and discipline unnecessary. The Exchange was largely governed by the personal ethical standards of its members. In *Belton v. Hatch*, the Court of Appeals of New York characterized the NYSE as a "business club."[19] This permitted the Exchange to "regulate its members as it saw fit" and provides an early example of a self-regulator assuming control of the discipline of industry participants.[20]

B. State Securities Regulation

As individual investors' access to the securities markets increased, states developed laws specifically regulating the offer and sale of securities to protect investors from fraud. State regulation originated as an exercise of state police power under the Tenth Amendment, with Kansas setting the standard by passing the first blue sky law in 1911.[21] The United States Supreme Court confirmed the constitutionality of state securities laws in *Hall v. Geiger-Jones Co.*[22] In *Hall*, multiple provisions of various blue sky laws were evaluated for their constitutionality. The blue sky law in Ohio provided that all dealers must be licensed before they were permitted to conduct business within the State. In holding the law Constitutional, the *Hall* Court found that the law was merely a regulation of business with the goal of protecting the public against the imposition of unsubstantial

http://www.szse.cn/main/en/AboutSZSE/Milestone/ (last visited June 2, 2012). China has adopted recent national regulation to cultivate worldwide investor confidence, gain access to the World Trade Organization, fund state owned entities (SOEs) with private investment dollars, and develop the country into a "social market economy." Upon the creation of the two major Chinese stock exchanges, the State Council of China established the China Securities Regulatory Commission which is similar to the SEC. *The China Securities Regulatory Commission: Dedicated to Protecting Investors' Rights and Interests*, CHINA SECURITIES REGULATORY COMMISSION, http://www.csrc.gov.cn/pub/csrc_en/about/ (last visited June 2, 2012).

18. NYSE Constitution of 1817, SEC HISTORICAL SOC'Y, *http://www.sechistorical.org/collection/papers/1810/1817_0225_NYSEConstitutionT.pdf.*

19. 17 N.E. 225, 226 (N.Y. 1888).

20. SEC HISTORICAL SOCIETY, *supra* note 17.

21. Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347 (1991). The State of Kansas at the time had a large proportion of agriculturalists not versed in ordinary business methods. By 1911, the state had become a hunting ground for promoters of fraudulent enterprises. Laws aimed to stop schemes which have no more bases than so many feet of blue sky became known as "blue sky" laws. Hall v. Geiger-Jones, 242 U.S. 539, 550 (1917).

22. *Hall*, 242 U.S. at 559.

schemes and the securities based upon them.[23]

To establish a uniform system of state securities regulation, the National Conference of Commissioners on Uniform State Laws prepared the Uniform Sale of Securities Act ("the Uniform Act") in October 1929. The majority of states have adopted blue sky regulations modeled after the Uniform Act.[24]

By 1931, every state had adopted some form of securities laws. Unlike the disclosure-based system of the later federal securities laws, all of the early state securities laws were "merit" review laws, providing the state regulator the authority to deny applications which were not fair, just, or equitable to investors or which were not based on sound business principles.[25] To increase efficiency, among other purposes, state regulators have worked cooperatively since 1919 through the North American Securities Administrators Association ("NASAA").

C. The Calm Before The Storm

After World War I, the retail investment industry experienced a period of sustained high growth as individual investors discovered the stock market in increasing numbers.[26] Stock prices soared, but the average investor was unaware that to a large extent those profits were a mirage, built on false promises. During this time, there were numerous examples of market manipulation and a failure of self-regulation. Stock pools were used to buy stock, boost the price, and then unload it at a profit.[27] Brokers would create a "swirl of phony trading" that would cause stock prices to skyrocket.[28] One example of such manipulation is the Libby Owens Security Trading Pool, managed by Joseph P. Kennedy.[29] False information, implying that Libby-Owens-Ford was on the rise, was leaked

23. *Id.* at 550.

24. The Uniform Act is a model law intended to provide each state with a guide to draft its securities law. Subsequent versions of the Uniform Act have been passed in 1956, 1985, and 2002.

25. *See generally* JOSEPH LONG, BLUE SKY LAW § 1:42 (discussing the "merit regulation" aspects of early state securities laws).

26. Andrew Beattie, *The Pioneers of Financial Fraud*, INVESTOPEDIA (Jul. 15, 2009), http://www.investopedia.com/articles/financial-theory/09/history-of fraud.asp#axzz1SyTOs2Wa.

27. *Stock Exchange Practices: Hearing Before the S. Comm. on Banking and Currency*, 72nd Cong., pt. 6 at 2204 (1933).

28. Randall Smith & Linda Sandler, *Raiders' Activities Revive Memories of 1920s Pools*, WALL STREET J., Nov. 10, 1986.

29. TED SCHWARZ, JOSEPH P. KENNEDY: THE MOGUL, THE MOB, THE STATESMAN, AND THE MAKING OF AN AMERICAN MYTH 177 (2003).

to "everyone who could influence the stock."[30] Kennedy is estimated to have made more than $60,000 on the stock run-up in four months.[31] Before the ensuing crash, Kennedy liquidated his long-term holdings and continued to make money on the declining market by selling short.[32]

The situation was exacerbated by the limited reach of state regulators, whose jurisdiction was limited to protecting their own respective citizens.[33] Generally, state regulators had little if any authority over national or even regional exchanges.

D. The Crash

On Tuesday, October 29, 1929, Americans witnessed the "most disastrous day in the stock market's history."[34] Prices collapsed under panic selling and the "pressure of liquidation of securities which had to be sold at any price."[35] In a single day, 16,410,030 shares were traded on the New York Stock Exchange.[36] By mid-November, the market had lost twenty-six billion dollars, or forty percent of its value.[37] The unemployment rate ballooned to nearly twenty-five percent. The existing securities regulatory structure had failed. The financial system needed drastic change, and in the 1932 election, the nation placed their faith in Franklin D. Roosevelt. The public blamed the industry for the national panic and what would be a long-term American economic depression.[38]

E. The Depression Inspires Federal Regulation

When Franklin Delano Roosevelt won the presidency in 1933, the

30. *Id.*

31. *Id.* Contrast the 1920s in the United States to the 1990s and 2000s in China when China faced extensive criticism for ineffective enforcement to catch insider trading. *See* Karby Leggett, *China Will Merge Its Two Stock Markets—Combined Bourse Will be in Shanghai; Start-Ups Will Trade in Shenzhen*, at A23, Wall Street J., Sept. 12, 2000.

32. SCHWARZ, *supra* note 29, at 177.

33. Pennsylvania Securities Act of 1972 § 702, 70 PA. CONS. STAT. § 1-702 (2011).

34. *Closing Rally Vigorous*, N.Y. TIMES, Oct. 30, 1929.

35. *Id.*

36. *Id.*

37. DAVID F. BURG, THE GREAT DEPRESSION 47 (Facts on File, Inc. 1996) (2005).

38. The massive social chaos, poverty and strife of the Great Depression are echoed today in the current global recession. An overall lack of government regulation of the largest and most powerful forces in today's financial markets has been well documented as one of the key culprits in today's "Great Recession." *See* Bruce Bartlett, *The Great Depression and The Great Recession*, FORBES.COM, http://www.forbes.com/2009/10/29/depression-recession-gdp-imf-milton-friedman-opinions-columnists-bruce-bartlett.html (last visited June 2, 2012) (comparing the circumstances leading up to the Great Depression the circumstances of the current economic crisis).

U.S. financial services industry was a sinking ship, taking on more water by the minute. The capsizing markets were a direct result of plummeting investor confidence, a crucial ingredient in stable retail securities markets.

In his inaugural address, Roosevelt called for swift and unilateral action. He openly condemned the practices of "unscrupulous money changers."[39] He declared that the "rulers of the Exchange of mankind's goods have failed through their own stubbornness and their own incompetence."[40]

With the scars of the 1929 crash still fresh, Roosevelt challenged Congress to create a system of strict supervision of all banking, credits and investments.[41] The implication was clear; Roosevelt recognized the shortcomings of the current regulatory system, including the failure of self-regulation, and the need for the federal government to manage the U.S. securities markets.

Congress responded quickly to Roosevelt's warnings and the national emergencies that ensued in the wake of failed self-regulation, and passed the Securities Act of 1933 ("the 1933 Act") in May of 1933. The 1933 Act regulates disclosure requirements in new issuances[42] to prevent fraud in the initial offer and sale of securities.[43]

Regulating just the initial sale of securities was insufficient, however. The secondary markets could not be left to national self-regulation. In a February 1934 statement to Congress, Roosevelt called for national regulation of the exchanges in order to eliminate widespread market manipulation and abuse. He admonished that "naked speculation has been made far too alluring and far too easy."[44]

At the President's request, Congress met to consider additional legislation and Congressional committees heard testimony from various industry professionals. These committees heard testimony on how the industry had grown so quickly. For example, in 1910 there were 500 branches of stock exchange houses and by 1929 there were 1,600.[45] Speculation grew as stock prices continued to climb. The Dow Jones

39. President Franklin D. Roosevelt, Inaugural Address (Mar. 4, 1933), *available at* http://www.bartleby.com/124/pres49.html.

40. *Id.*

41. *Id.*

42. MARC STEINBERG, UNDERSTANDING SECURITIES LAW 115 (5th ed. 2009).

43. *Id.*

44. President Franklin D. Roosevelt, Address to Congress (Feb. 6, 1934), *available at* http://c0403731.cdn.cloudfiles.rackspacecloud.com/collection/papers/1930/1934_02_06_FDR_on_Stock_Exch.pdf.

45. *Stock Exchange Practices: Hearing before the S. Comm. on Banking and Currency*, 73d Cong., pt. 15 at 6437 (1934).

Industrial Average rose from 73 in 1921 to 313 in 1929.[46] Brokers' loans increased from $1.5 billion in 1922 to $8.5 billion in 1929. More than ten billion dollars of new stock was issued in 1929 alone. In the crash of October 1929, brokers' loans collapsed by three billion dollars in ten days, and by eight billion dollars in the following three years. The Dow Jones Industrial Average declined by an astounding eighty-nine percent between September 1929 and July 1932.[47]

Based on these considerations, Congress passed the Securities and Exchange Act in 1934 ("the 1934 Act"). The 1934 Act regulated the sale of securities in the secondary market and created the SEC.[48] Joseph Kennedy, with his reputation for unscrupulous market manipulation, was placed at the helm of the fledgling organization.[49] Roosevelt is said to have responded to criticism of the appointment by saying "it takes a thief to catch a thief."[50] So, who better than Kennedy to lead the new experiment in federal securities regulation?

The 1934 Act recognized that the trading of securities has national implications; hence, it is necessary to provide for government regulation and control of such transactions to protect the general welfare of the country.[51] Specifically, one portion of the 1934 Act sought to increase margin requirements to make it more difficult for brokers and dealers to borrow to trade.[52] Before the 1934 Act, the exchanges made their own rules regarding buying on margin. Margins as high as ninety percent of trade amounts were not uncommon. Section 7 of the 1934 Act made it clear that Congress was to "prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security or a security futures product)."[53]

46. *Dow Jones Average Yearly Change*, AUTOMATIONINFORMATION.COM, http://www.automationinformation.com/DJIA/dow_jones_average_yearly_change.htm (last visited June 2, 2012).

47. *DJI Historical Prices | Down Jones Industrial Average Stock*, YAHOO! FINANCE, http://finance.yahoo.com/q/hp?s=%5EDJI&a=08&b=1&c=1929&d=07&e=1&f=1932&g=m (last visited June 2, 2012).

48. Securities and Exchange Act of 1934 § 4(a), 15 U.S.C. § 78d-1 (2006).

49. *Timeline*, SECHISTORICAL.ORG, http://www.sechistorical.org/museum/timeline/ (last visited June 2, 2011).

50. Mike Brewster, *Joseph Kennedy's Enduring Example*, BLOOMBERG BUSINESSWEEK, May 29, 2003, http://www.businessweek.com/bwdaily/dnflash/may2003/nf20030529_7026.htm.

51. § 2, 15 U.S.C. § 78b (2006).

52. *Stock Exchange Practices:* Hearing before the S. Comm. on Banking and Currency, 73d Cong., pg. 15 (1934).

53. § 7, 15 U.S.C. § 78g (2006).

F. *Over-the-Counter Regulation*

In 1934, NYSE President Richard Whitney presciently warned that the 1934 Act was "rigid and inflexible" in its regulation of the U.S. exchanges.[54] He predicted that the 1934 Act would deflate securities prices and hinder economic recovery.[55] The 1934 Act's regulation of the exchanges was comprehensive, and included requirements for minimum capitalization, outstanding shares, and minimum stock prices.[56] To escape the regulatory spotlight, many securities issuances simply avoided the listing standards of the exchanges and traded over-the-counter ("OTC") instead.[57] The OTC markets were left largely unregulated by the 1934 Act. OTC issuances did not have the disclosure requirements placed on exchange-traded securities.[58] By 1938, it was obvious that OTC trading, which encompasses "all transactions in securities which take place otherwise than upon a national securities exchange," blossomed in the absence of regulation.[59]

In congressional testimony in 1938, SEC Commissioner and former Wisconsin securities regulator George C. Mathews highlighted the dangers of unsupervised OTC trading. He vividly described the OTC markets as "unorganized" and unregulated.[60] OTC trading was "immense and varied."[61] In 1938, 6,766 brokerage firms were registered with the SEC as transacting business in the OTC markets.[62] In comparison, there were only 1,375 members of the New York Stock Exchange.[63] At the time of Mathews' testimony, 6,000 separate issues of stocks and bonds were admitted to trading on all U.S. stock exchanges.[64] In stark contrast, there were 60,000 total stock issues trading on the OTC markets.[65] Indeed, Mathews estimated that the OTC markets provided the "principal channel

54. Letter from Richard Whitney, President, New York Stock Exchange, to Franklin D. Roosevelt, U.S. President, (Apr. 12, 1934) *available at* http://c0403731.cdn.cloudfiles.rackspacecloud.com/collection/papers/1930/1934_04_12_Whitney_to_FDR.pdf.

55. *Id.*

56. §§ 12, 13, 15, 15 U.S.C. § 78l (2012).

57. *Regulation of Over-the-Counter Markets: Hearings before the S. Comm. on Banking and Currency*, on S. 3255, 75th Cong., at 14 (1938).

58. *Id.*

59. *Id.* at 12 (statement of George C. Mathews, Commissioner, Securities and Exchange Commission).

60. *Id.* at 7.

61. *Id.* at 12.

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.*

for the flow of the savings of our people into new financing."[66] Further, Mathews opined that direct governmental control of OTC trading was impractical and prohibitively expensive. He believed that governmental control would be complex, like "trying to build a structure out of dry sand."[67]

In light of these observations, Congress passed the Maloney Act in 1938.[68] With this amendment to the 1934 Act, Congress sought to "encourage over-the-counter dealers to organize and regulate their activities under governmental supervision."[69] The premise behind the amendment was that "[a] group which participates in the promulgation of a rule . . . will obey that rule better than if it did not share in its enactment."[70] Congress wanted to create a variety of organizations in which brokers and dealers could register to promote voluntary compliance with ethical standards. Indeed, under the Maloney Act, "more than one association of broker dealers could apply for recognition, yet only one did—the National Association of Securities Dealers ("NASD").[71]

G. *Ushering in the Modern Era*

In 1975, the 1933 and 1934 Acts were amended to give the SEC the power to initiate and approve SRO rule making. The amendment expanded the SEC's role in SRO enforcement, oversight, and discipline, which allowed the SEC to play an active role in structuring the public securities markets.[72]

Initially, the exchanges were non-profit organizations. In 2005, by virtue of its merger with Archipelago Holdings Inc., an electronic communications network,[73] the NYSE became a public company.[74] As a result, the public could own shares in the stock exchange, and the exchange was answerable to its shareholders.[75] As a public company, the NYSE was

66. *Id.* at 13.
67. *Id.* at 8.
68. Over-the-Counter Market Act, Pub. L. No. 75-719, 52 Stat. 1070 (1938) (codified as amended at 15 U.S.C. § 78o-3).
69. Tamar Hed-Hofmann, *The Maloney Act Experiment*, 6 B.C. INDUS. & COM. L. REV. 187 (1965).
70. *Id.* at 210.
71. *Id.* at 187.
72. Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified as amended in scattered sections of 15 U.S.C.).
73. Yesenia Cervantes, Note, *"Fin Rah!" . . . A Welcome Change: Why the Merger Was Necessary to Preserve U.S. Market Integrity*, 13 FORDHAM J. CORP & FIN. L. 829, 836 (2008).
74. *Id.*
75. *Id.* The NYSE merged with Euronext in 2007, which runs exchanges in Paris,

focused on making a profit, which begs the modern question: can the exchanges effectively self-regulate if their ultimate goal is to generate their own profit?

In 2007, the NASD merged with the regulatory arm of the NYSE to create FINRA. The two organizations announced that they wanted to form a "private sector regulator for all securities brokers and dealers doing business with the public in the United States."[76] Advocates asserted that the merger would ultimately decrease compliance costs, a savings which could be passed along to customers.[77] Critics alleged that the merger would make enforcement a lower priority.[78]

Today, FINRA oversees nearly 4,900 brokerage firms, 167,000 branch offices, and approximately 660,000 registered securities representatives.[79] FINRA has approximately 3,000 employees, with headquarters in Washington, D.C. and New York, and twenty regional offices.[80]

The American regulatory system has placed significant faith in the concept of self-regulation in recent decades. However, the current system has come under criticism for failing to prevent many of the major securities scandals since the 1980s.[81] Most recently, the Bernard Madoff scheme went undetected for more than a decade. Will self-regulation be effective in the American retail securities markets in the future, particularly in enforcement activities?

Amsterdam, Brussels and Portugal making the NYSE. Cervantes, *supra* note 73, at 843.

76. Press Release, Financial Industry Regulatory Authority, NASD and NYSE Group Announce Plan to Consolidate Regulation of Securities Firms (Nov. 28, 2006), *available at* http://www.finra.org/Newsroom/NewsReleases/2006/P017973.

77. Carrie Johnson, *SEC Approves One Watchdog For Brokers Big and Small*, WASH. POST, July 27, 2007, http://www.washingtonpost.com/wp-dyn/content/article/2007/07/27/AR2007072700108.html

78. *Id*.

79. *FINRA Statistics*, FINRA.ORG, http://www.finra.org/Newsroom/Statistics/index.htm (last viewed Aug. 28, 2011).

80. *Id.* Since 2008, Britain and the rest of Europe have been moving towards more governmentally controlled regulators, because the modern weaknesses of the financial services industry have been exposed and the global recession has occurred. *See* Michel Banier, European Commissioner for Internal Market and Services, *The Date of 1st January Marks a Turning Point for the European Financial Sector*, EUROPEAN COMMISSION (Jan. 1, 2011), http://ec.europa.eu/commission_2010-2014/barnier/headlines/speeches/2011/01/20110101_en.htm (announcing the development of three European Supervisory Authorities—in banking, markets, and insurance and pensions—that will cooperate with the European Systemic Risk Board).

81. Letter from Danielle Brian, Executive Director, Project on Government Oversight, to Congress (Feb. 23, 2010), *available at* http://www.pogo.org/pogo-files/letters/financial-oversight/er-fra-20100223-2.html.

II. CURRENT CONCERNS AND CHALLENGES IN AMERICAN SECURITIES REGULATION

A. The Underlying Problem with Self-Regulation

Self-regulation has always presented the proverbial problem of the "fox guarding the henhouse." In the bright light of day, the fox dutifully guards his post. His watchful eyes are ready; his ears piqued to hear even the slightest whisper of a sound. Inevitably, the sun fades and the shadowy hand of night sweeps across the horizon. The fox abandons his post and slips surreptitiously inside the henhouse. He has no apprehension, no reason to look over his shoulder. He answers to no one. He makes his own rules. He is his own regulator, motivator, and enforcer. Such is the dilemma faced by any group governed by the pure principle of self-regulation.

B. Structural Issues with SROs

In addition to inherent theoretical problems with self-regulation, the structural framework of the SRO model itself raises questions of whether it can lead to effective regulation. As the Boston Consulting Group pointed out in its study mandated by the Dodd-Frank Act, "[t]he most fundamental critique is that self-regulation is not real regulation at all: at best, self-regulation is less effective than government regulation, and at worst, is merely 'an illusion' meant to deflect calls for government oversight."[82]

The following section addresses the shortcomings of the current SRO structure as it applies to the overall regulatory landscape. While we highlight FINRA for specific examples, in most instances these shortcomings apply to all SROs.

1. The State Actor Issue

One controversial issue concerning American SROs and their role in the regulatory community is the "state actor" or "governmental actor" question. Essentially, is the SRO acting as the government, or is it acting as a private "membership" entity? The U.S. Constitution protects a wide variety of individual freedoms. These protections, however, only apply to governmental conduct. Whether an SRO is deemed to be a state or governmental actor has significant implications for its ability to investigate

82. BOSTON CONSULTING GROUP, SECURITIES AND EXCHANGE COMMISSION: ORGANIZATIONAL STUDY AND REFORM 25 (2011) [hereinafter BOSTON CONSULTING GROUP], *available at* http://www.sec.gov/news/studies/2011/967study.pdf.

and discipline its members, as well as for its ability to share information with other regulators and law enforcement officials. For example, in recent years FINRA has been reluctant to share investigative material in ongoing investigations with state regulators, claiming that such sharing could make FINRA a "government actor."[83]

The state actor issue is best highlighted in the context of FINRA Rule 8210, which requires members and persons associated with members to provide information and testimony with respect to an investigation, complaint, or proceeding authorized by FINRA.[84] FINRA may sanction members for failure to provide information and testimony requested under Rule 8210.[85] The Rule provides a means for FINRA to carry out its regulatory functions in the absence of subpoena power and is a "key element in [FINRA's] effort to police its members."[86]

Rule 8210(b) further provides that FINRA may share investigative material with other federal agencies and regulators.[87] What happens, then, when a FINRA member, who is or may be the subject of a criminal proceeding, is requested to give testimony or provide documents under Rule 8210? Can the FINRA member invoke the Fifth Amendment privilege, which provides that "[n]o person shall . . . be compelled in any criminal case to be a witness against himself?"[88] If FINRA is not a "state actor," the Fifth Amendment privilege is unavailable and the FINRA member risks sanctions, including suspension or revocation of his registration, for refusing to cooperate.

In general, the Fifth Amendment privilege does not apply to questioning in proceedings before SROs such as FINRA, because the regulatory activities of such entities do not rise to the level of "state action."[89] Conduct by FINRA and other SROs *may* be treated as "state action" if it is found to be "fairly attributable" to the government.[90] When considering cases under the state actor doctrine, courts generally require one of three circumstances: (1) the exercise of coercive power or significant encouragement by the government of the activity in question;

83. *Finra Oversight Could Cost Investors*, FA-MAG.COM (June 28, 2011), http://www.fa-mag.com/fa-news/7790-finra-oversight-could-cost-investors.html.

84. FINRA R. 8210 (FINRA 2010), *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=13244&element_id=3883&highlight=8210#13244.

85. *Id.*

86. Application of Richard J. Rouse, Exchange Act Release No. 32658, 1993 WL 276149 (July 19, 1993).

87. FINRA R. 8210 (FINRA 2008), *available at* http://finra.complinet.com/en/display/display.html?rbid=2403&record_id=13244&element_id=3883&highlight=8210#13244.

88. U.S. CONST. amend. V.

89. United States v. Solomon, 509 F.2d 863, 867 (2d Cir. 1975).

90. *Id.*

(2) performance of a traditional governmental function by a private entity; or (3) a "symbiotic" interdependence between the government and the private entity.[91]

Courts addressing the specific issue of the Fifth Amendment privilege, however, have consistently found that the mere sharing of investigative information without indicia of entwinement by the SEC or another governmental agency is not sufficient to establish a state action.[92] The *Solomon* and *D.L. Cromwell*[93] cases illustrate this position. In *Solomon*, the NYSE took testimony from a trader under threat of suspension or expulsion, and then forwarded the deposition transcript to the SEC pursuant to a subpoena.[94] In *Cromwell*, the NASD and federal prosecutors simultaneously investigated plaintiff stockbrokers, who in turn sought to enjoin the NASD from compelling on-the-record interviews. Citing the Fifth Amendment privilege, the plaintiffs claimed that the NASD inquiry was merely a tool for prosecutors, pointing out that the NASD interview demands followed shortly after plaintiffs contested grand jury subpoenas.[95]

In both cases, the courts held that there was no "state action," because the SROs had independent regulatory interests and motives for conducting their respective inquiries. In *Cromwell*, the NASD had a preexisting "regulatory duty to investigate questionable securities transactions."[96] In *Solomon*, the court found that the NYSE activities were "in pursuance of its own interests and obligations, not as [an] agent of the [government]."[97] In other words, in both cases the SRO would have been conducting investigations anyway, regardless of the governmental interest.

Nevertheless, the SEC has recently acknowledged that under some circumstances an SRO may be acting as an agent for the government in conducting the investigation. For example, in *Frank P. Quattrone*,[98] a person asserted his Fifth Amendment privilege in response to a request for testimony by the NASD under Rule 8210 because of a related pending criminal indictment against him. Quattrone sought to present evidence that

91. Application of Justin F. Ficken, Exchange Act Release No. 54699, 2006 WL 3147424, at *3–5 (Nov. 3, 2006).

92. *See* Frank P. Quattrone, Exchange Act Release No. 53547, 2006 SEC LEXIS 703, at *22 (Mar. 24, 2006) (noting that applicable law requires a "requisite degree of coordination," but that collaboration alone generally cannot constitute state action).

93. D.L. Cromwell Invs., Inc. v. NASD Regulation, Inc., 279 F.3d 155 (2d Cir. 2002).

94. *Solomon,* 509 F.2d at 864–65.

95. *Cromwell*, 279 F.3d at 156–57.

96. *Id.* at 163.

97. *See Solomon*, 509 F.2d at 869 (basing its holding on the additional fact that a contrary holding would create a power in the SRO to grant "use immunity" without the supervision of the Attorney General to which governmental agencies are subjected).

98. Frank P. Quattrone, Exchange Act Release No. 53547, 2006 SEC LEXIS 703 (Mar. 24, 2006).

the NASD request related to a joint investigation by the SEC, FINRA, and the NYSE into research analysts' conflicts of interest, and that those entities decided that the NASD would lead the investigation.[99] The hearing panel precluded Quattrone from presenting such evidence.[100] The SEC reversed and remanded the administrative decision, holding that Quattrone had the right to present evidence that the NASD's role in the joint investigation rendered it a "state actor."[101]

It should be noted that, although courts and the SEC have generally treated FINRA as a private non-governmental body in cases addressing the Fifth Amendment privilege, cases involving the immunity of FINRA from lawsuits generally uphold that immunity based on the view that FINRA "should be entitled to the same immunity enjoyed by the SEC when it is performing functions delegated to it under the SEC's broad oversight authority."[102] While these stances appear to be irreconcilable, they do represent a level of deference given to SROs in performing their regulatory responsibilities. From a purely practical perspective, sovereign immunity is as necessary for an SRO to satisfy its regulatory responsibilities as is the ability to compel cooperation in investigations. The fact that the legal support for these important "necessities" has generated diametrically opposed decisions appears to be beside the point.

While FINRA's capacity to compel its members to cooperate with investigations without triggering the "state actor" doctrine is undoubtedly important, FINRA's interpretation of its limitations under the "state actor" doctrine is problematic. Under current FINRA policy, FINRA will not conduct "joint" examinations or investigations with state securities regulators, nor will it provide state securities regulators access to open FINRA investigations. Because FINRA and the states have overlapping jurisdiction and responsibilities, the sharing of information is vital to regulatory cost, conservation, and effectiveness.[103]

99. *Id.*

100. *Id.*

101. *Id.*

102. D'Alessio v. N.Y. Stock Exch., Inc., 258 F.3d 93, 105 (2d Cir. 2001); *see also* Scher v. Nat'l Assoc. of Sec. Dealers, Inc. (NASD),, 218 Fed. App'x 46 (2d Cir. 2007) (holding that NASD actions were actions within the scope of regulatory authority and were correspondingly entitled to immunity); Barbara v. N.Y. Stock Exch., 99 F.3d 49 (2d Cir. 1996) (concluding that NASD had absolute immunity from liability arising out of administration of its disciplinary function).

103. State securities laws uniformly provide for the sharing of investigative material with other regulators, governmental agencies, and SROs. *See* UNIFORM SECURITIES ACT § 608 (amended 2002) (requiring cooperation, coordination, consultation, and record sharing among agencies); UNIFORM SECURITIES ACT § 415 (amended 1956).

2. Lack of Transparency and Accountability

One of the pillars of a democratic society is public access to the workings of government. Federal and state legislative sessions and hearings are generally open to the public. Moreover, members of the public can walk into any court in the country and watch the proceedings. The federal Freedom of Information Act (FOIA) and the state counterparts allow for public inspection of governmental documents.[104]

SROs, however, are not the government. Their decisions are not made in public meetings, nor are their documents subject to FOIA or other similar public records requirements. Even where there is public disclosure by an SRO regarding its members, such as information available on BrokerCheck, the SRO has placed limitations on such disclosure[105] In the end, members of the public receive less information than they would if a government agency were involved, and may not be able to obtain the information they need to make informed decisions. Likewise, SROs lack the accountability to the public that governmental agencies have. Ironically, administrative agencies have been criticized in the past for lacking accountability. Congress has the power to enact laws and is directly answerable to the public through the ballot box; yet, administrative agencies, which have the authority to promulgate rules and regulations that have the force and effect of law, are not. Courts generally have found that administrative law is implied by Article I of the U.S. Constitution, so long as agencies are created by Congress and act consistent with enabling legislation it passes.[106]

In this light, SROs are further removed than governmental agencies. FINRA, for example, is accountable to the SEC, which has oversight authority over it, and to its own members. FINRA need not, however, be responsive to the investing public. This lack of accountability prompted the Boston Consulting Group to call for the enhancement of SEC oversight of FINRA.[107]

104. Freedom of Information Act, 5 U.S.C. § 552 (2006) (original version at 80 Stat. 378, 383 (1966)); Right-to-Know Law, 65 PA. CONST. STAT. §§ 65.101–67.3104 (2012).

105. BrokerCheck is an online tool that provides information concerning current and former FINRA-registered brokerage firms and brokers, and is found at http://www.finra.org/investors/toolscalculators/brokercheck/.

106. *See generally* Administrative Procedure Act, 5 U.S.C. §§ 500-04, 551–59, (2006) (explaining generally the validity of administrative law created by valid Congressional agencies).

107. BOSTON CONSULTING GROUP, *supra* note 82, at 135.

3. Inconsistent Enforcement Authority

The recent case of *John J. Fiero and Fiero Brothers, Inc. v. FINRA* highlights the fact that the enforcement authority granted to SROs by Congress under the 1934 Act does not necessarily mirror the enforcement authority granted to the SEC itself.[108] In *Fiero Brothers*, the Second Circuit held that FINRA lacks the authority to bring court actions to collect disciplinary fines. In that case, the Fiero Brothers were expelled from FINRA and fined $1,000,000 plus costs. After the Fieros refused to pay the fine, FINRA brought an action in federal court to enforce the judgment. The court of appeals found that even though Congress granted the SRO the authority in section 15A(b) of the 1934 Act to fine its members for violations, it did not provide any express statutory authority for an SRO to bring judicial actions to enforce the collection of those fines.[109] In contrast, Congress granted in section 21(d) of the 1934 Act the express statutory authority for the SEC to seek judicial enforcement of penalties.[110] This clear absence of enforcement power dilutes FINRA's deterrent threat.

4. Conflicts of Interest

Like any SRO, FINRA, by its very nature, is plagued by at least the appearance of inherent conflicts of interest. Any conflict of interest, however attenuated, invariably raises the question: whose side is the SRO on?

a. Funding and Executive Compensation

Any review of how SROs are funded in contrast to the government agency that oversees them inevitably will spotlight flaws in this regulatory framework. For example, the SEC is funded primarily from the transfer and registration fees from stock trades.[111] Those fees, which in 2010 generated approximately $1,443,000,000, are deposited with the Treasury in the first instance.[112] The SEC must then petition Congress with its proposed budget for an appropriation, currently at the $1,120,000,000 level, which is significantly less than the SEC requested and the amount of

108. 550 F.3d 569 (2d Cir. 2011).
109. 15 U.S.C. § 78o-3(b)(7) (2006).
110. *See* 15 U.S.C. § 78u(d) (2006) (granting authority to courts to issue injunctions and money penalties in civil actions).
111. *Should the SEC be Self-Funded?* Kathleen McBride, ADVISORONE, Aug. 10, 2009, http://disqus.com/forums/advisorone/should_the_sec_be_self_funded_59/trackback/.
112. *Id.*

fees it generated.[113] Likewise, employees of the SEC are paid in line with federal government pay scales.[114] The SEC Chairwoman is paid $158,500 per year. [115]

In contrast, FINRA is largely funded by the businesses it supervises.[116] FINRA's operating revenue for the 2010 fiscal year was $807,900,000.[117] The vast majority of that operating revenue ($796,500,000 out of $807,900,000) was earned through fees charged to FINRA members and member firms.[118] From the amount of operating revenue, $540,300,000, or 66.9%, was spent on compensation and benefits.[119] Eight out of FINRA's top ten executives earned in excess of $1,000,000 in 2010 in their posts.[120]

FINRA's compensation packages are modeled after executive compensation plans at financial services and capital markets firms.[121] The NASD Chairman's earnings rose from $2,100,000 in 2001 to $3,140,826 in 2007.[122] In 2010, the Chairman and Chief Executive Officer of FINRA made a base salary of $1,000,000 and earned a total of $2,609,354.[123]

That FINRA's budget is substantially sourced from the brokers it regulates, combined with the fact that FINRA executives are paid large salaries, does raise concern.[124] If executives are paid relatively opulent salaries by the brokers whom they police, the motivation to regulate can easily be dampened. In today's post-Sarbanes-Oxley world, where public

113. *Id.*

114. *2011 Salary Tables and Related Information*, U.S. OFFICE OF PERS. MGMT., http://www.opm.gov/oca/11tables/index.asp (last visited June 2, 2012).

115. Before the Financial Services Authority was set to be disbanded, it was criticized in the British press for how it compensated its own staff. In 2008, the Telegraph reported that "[the FSA] employs 2,740 staff, who last year were paid on average £77,000 in salaries, training and pensions. The six directors were paid an average of £490,000." These figures were then compared by the former FSA Chairman, Lord Turner, as "far lower than his fellow regulators received in America." Harry Wallap & David Litterick, *FSA Chief Lord Turner Under Fire as He Calls for Regulator to Be Given More Money*, THE TELEGRAPH, Oct. 17, 2008, http://www.telegraph.co.uk/finance/financialcrisis/3217798/FSA-chief-Lord-Turner-under-fire-as-he-calls-for-regulator-to-be-given-more-money.html.

116. 2010 FINRA YEAR IN REV. & ANN. FIN. REP. 8, http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p123836.pdf.

117. *Id.*

118. *Id.*

119. *Id.*

120. *Id.* at 18.

121. *Id.*

122. Rosie Levan, *SEC's New Chairman: Who is Mary Schapiro?,* THE SUNDAY TIMES, Dec. 18, 2008, http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article5364844.ece.

123. 2010 FINRA YEAR IN REV. & ANN. FIN. REP. 18.

124. The FSA was funded by the banks and financial institutions themselves, who are levied an annual fee. In 2007, its budget was reported to have totaled £303 million. *See* Wallap & Litterick, *supra* note 115.

companies are being held to higher standards of independence at the board of director level, the compensation structure at FINRA at least has the appearance of potential impropriety. Does a pattern of plentiful executive compensation incentivize effective regulation when FINRA's budget is paid by the industry it is intended to regulate?

Lynn Turner, former chief accountant for the SEC, believes that the FINRA compensation practices cannot promote investor protection.[125] According to Turner, "[t]he economic incentives are so strong and these executives don't want to make waves and upset the industry."[126] Richard Ketchum, FINRA Chairman and CEO, counters this argument by stating that high executive compensation helps to prevent turnover and encourages people to "make a career out of regulation."[127]

Finally, it should be noted that FINRA makes investments in the securities markets, which also gives rise to potential conflicts of interest. For example, in its 2008 annual report, FINRA described the collapse of the auction rate securities (ARS) market.[128] However, it failed to mention that it liquidated its own $647,000,000 ARS investment in 2007, without giving warning to investors.[129] Regardless whether such warnings were warranted at the time, the mere fact that FINRA had substantial amounts invested in securities which have since been the subject of fraud investigations points to a potential conflict of interest that would not have been triggered if a government regulator were involved.

b. Selection Process for FINRA Executives

FINRA often solicits executives from financial services and capital markets companies it regulates. FINRA states that such industry players are "the most likely group for recruiting talent as well as those that recruit talent away from [FINRA]."[130] Some would argue that this close relationship blurs the line between FINRA and the industry, weakening the drive for aggressive regulation. The Project on Government Oversight, for

125. Alexis Leondis & Zeke Faux, *Investors May Lose as Congress Saves Money on Adviser Oversight*, BLOOMBERG NEWS, June 28 2011, http://www.bloomberg.com/news/2011-06-28/investors-may-lose-as-congress-saves-money-on-adviser-oversight.html.

126. *Id.*

127. *Id.*

128. 2008 FINRA YEAR IN REV. & ANN. FIN. REP. 2, http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p119061.pdf.

129. Letter from Larry Doyle, Author, *Sense on Cents* Blog, to the Board of FINRA (Jul. 27 2009), *available at* http://www.senseoncents.com/2009/07/an-open-letter-to-the-board-of-finra-regarding-auction-rate-securities/.

130. FIN. SERVS. REGULATORY AUTH., FINRA 2010 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT 17 (2010).

example, describes the relationship as "incestuous."[131]

Just how close is the relationship between FINRA and the industry? A recent court filing describes a web of conflicts. In a complaint filed in August 2009, Amerivet Securities, Inc., a FINRA member-firm, accused FINRA of egregious conflicts of interest. Specifically, the complaint alleges:

> Bernard Madoff joined NASD's Board of Governors in January 1984 and served as Vice Chairman while his Ponzi scheme was well underway;[132]
> He had previously held a number of NASD committee assignments since the 1970s and was instrumental in the development of the NASDAQ;[133]
> He also headed NASDAQ;[134] His brother, Peter Madoff, served as Vice Chairman of NASD;[135]
> Mark Madoff, one of Bernard Madoff's sons, was appointed to the National Adjudicatory Council, a regulatory body that reviews disciplinary decisions made by FINRA;[136] and
> Bernard Madoff's niece, Shana Madoff, a "Compliance Officer" of Madoff until the firm's collapse, was a member of a compliance advisory committee of FINRA.[137]

The Board of Governors is FINRA's "governing body," and consists of 16 to 25 members.[138] Governors are nominated by a Nominating Committee, comprised of a portion of the Board. Governors are then selected by FINRA's membership at an annual meeting. In turn, FINRA's officers are elected by its Board of Governors.[139]

FINRA's bylaws state that "the number of Public Governors shall exceed the number of Industry Governors."[140] The bylaws define a "public governor" as an individual having "no material business relationship with a broker or dealer or a self[-]regulatory organization registered under the Act (other than serving as a public director of such a self[-]regulatory

131. Brian, *supra* note 81.
132. Complaint at ¶ 27 n.4, Amerivet Secs., Inc. v. Fin. Indus. Regulatory Auth., No. 2009 CA 005767 B (D.C. Sup. Ct. Aug. 10, 2009).
133. *Id.*
134. *Id.*
135. *Id.*
136. *Id.*
137. *Id.*
138. FINRA BYLAWS, ARTICLE VII, § 1(A), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4629.
139. FINRA BYLAWS, ART. VIII, § 1, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4645.
140. FINRA BYLAWS, Art. VII, § 4(1), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4632.

organization)."[141]

The process for selecting FINRA's executive leadership is largely controlled by industry players. FINRA's membership consists of brokers and brokerage firms.[142] These members elect the Board. The Board then selects the executive officers. FINRA has attempted to prevent conflicts of interest by stating that the Board must consist of a majority of public governors.[143]

Notwithstanding these attempted safeguards, FINRA's leadership maintains a close relationship with the financial services industry. For example, before joining FINRA, its CEO was a senior manager at Citigroup Inc., serving as general counsel and sitting on several committees.[144] On one hand, industry professionals may have firsthand perspectives on how to improve regulation. However, industry insiders may also instinctively proceed with a light touch when regulating their former peers.

c. FINRA Arbitration Process and Awards

Almost every brokerage firm includes in its customer agreements a mandatory pre-dispute arbitration provision. If a case is not settled, the only alternative is arbitration, and the only arbitration forum available to investors is the one administered by FINRA. Although arbitration has been presented to the public as an inexpensive method of obtaining a speedy and fair resolution of the controversy, statistics do not support such claims.

A review of FINRA arbitration and mediation statistics tells us that only a fraction of the damages suffered are awarded to claimants.[145] In 2010, the median amount sought in compensatory damages through FINRA arbitration was $310,000.[146] The median amount awarded was $129,800.[147] Only forty-seven percent of claimants were awarded any amount of damages at all in an arbitration hearing.[148] Additionally, claimants must

141. FIN. SERVS. REGULATORY AUTH., ARTICLE I DEFINITIONS http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4599 (last visited Apr. 7, 2012).

142. *About the Financial Industry Regulatory Authority,* FINRA.ORG http://www.finra.org/AboutFINRA/ (last visited June 2, 2012).

143. FIN. SERVS. REGULATORY AUTH.,, ARTICLE VII BOARD OF GOVERNORS, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4599.

144. Richard G. Ketchum, FINRA.ORG, http://www.finra.org/AboutFINRA/Leadership/p019335 (last visited June 2, 2012).

145. Leondis & Faux, *supra* note 126.

146. *Id.*

147. *Id.*

148. *Dispute Resolution Statistics*, FINRA.ORG, http://www.finra.org/arbitrationandmediation/FINRADisputeResolution/AdditionalResources/Statistics/ (last visited June 2,

pay significant filing fees in order to initiate the FINRA arbitration process.[149] In 2011, arbitration claims involving a hearing took an average of fourteen months to conclude, hardly indicative of a "speedy" resolution of cases.[150]

The investing public may well ask, if the system were truly fair, why is arbitration universally demanded by brokerage firms? It is not surprising that the investing public does not have confidence in the arbitration system for a fair resolution of claims.[151] One reason for the low "success" rate for investors in arbitration is the FINRA rule that, until recently, an "industry" arbitrator was mandated on a panel of three in claims where the amount in controversy exceeded $100,000.[152]

The FINRA dispute resolution process is subject to SEC oversight, including periodic examinations, approval of rule and substantive procedural changes, and review of investor complaints.[153] However, FINRA readily admits that "[a]ll awards [. . .] are final and are not subject to review or appeal, except under limited circumstances."[154] Also, it is sometimes difficult for certain regional offices to retain highly qualified arbitrators though FINRA Dispute Resolution (DR) "constantly reviews the quality of the arbitration roster through . . . reviews conducted by the regional offices."[155]

2012).

149. Glenn Curtis, *When a Dispute with your Broker Calls for Arbitration*, INVESTOPEDIA (Aug. 14, 2007), http://www.investopedia.com/articles/07/arbitration.asp#axzz1SyTOs2Wa.

150. *Arbitration & Mediation*, FINRA.ORG (last visited June 2, 2012), *available at* http://www.finra.org/ArbitrationMediation/.

151. For example, a recent study commissioned by the Securities Industry Conference on Arbitration found that sixty-two percent of customers in arbitration felt the process was unfair. Jill I. Gross, *Perceptions of Fairness of Securities Arbitration: An Empirical Study*, Feb. 6, 2008, *available at* http://www.publicjustice.net/Repository/Files/Perceptions%20of%20Fairness.pdf.

152. To FINRA's credit, a recent rule allows claimants in arbitration the choice to have three "public" arbitrators in such cases. *See* FINRA R. 12403(a), (b), and (d) (FINRA 2010), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4141 (providing customers in cases with three arbitrators to choose between two selection methods).

153. SECS. AND EXCH. COMM'N, INVESTOR ADVISORY COMMITTEE PANEL ON SECURITIES ARBITRATION—MAY 17, 2010 FINANCIAL INDUSTRY REGULATORY AUTHORITY STATEMENT ON KEY ISSUES (2010), *available at* http://www.sec.gov/spotlight/invadvcomm/iacmeeting051710-finra.pdf.

154. *Arbitration & Mediation*, FINRA.ORG, http://www.finra.org/ArbitrationMediation/ (last visited June 2, 2012).

155. *Arbitration & Mediation*, FINRA.ORG, http://www.finra.org/ArbitrationMediation/FINRADisputeResolution/AdditionalResources/FAQ/P123925. (last visited June 2, 2012)

d. *Duplicative Roles for Multiple Regulators*

For as many gaps that exist in the current regulatory system, under a certain light, the system can also be considered duplicative in certain areas. State regulators, the SEC, and FINRA often undertake similar tasks, investigate the same information, and compete for the same resources.

For example, NASAA describes the role of state securities regulators as:

> LICENSING stockbrokers, investment adviser firms (those managing less than $25 million in assets),[156] and securities firms that conduct business in the state.[157]
> REGISTERING certain securities offered to the states' investors.[158]
> INVESTIGATING investor complaints and potential cases of investment fraud.[159]
> ENFORCING state securities laws by fining, penalizing, providing restitution to investors, prosecuting white-collar criminals, and imposing legally binding conduct remedies designed to correct specific problems.[160]
> EXAMINING brokerage and investment adviser firms to ensure compliance with securities laws and maintenance of accurate records of client accounts.[161]
> REVIEWING certain offerings that are not exempt from state law.[162]
> EDUCATING investors about their rights and providing the tools and knowledge they need to make informed financial decisions.[163]
> ADVOCATING passage of strong, sensible, and consistent state securities laws and regulations.[164]

Similarly, FINRA's website proclaims that it "touches virtually every aspect of the securities business."[165] This includes registering and educating industry participants, examining securities firms, writing rules,

156. This figure has been increased to one hundred million dollars in assets by section 410 of the Dodd-Frank Act, 15 U.S.C. § 80b-3a(a) (2012).
157. *The Role of State Securities Regulators*, NASAA.ORG, http://www.nasaa.org/about-us/our-role/.
158. *Id.*
159. *Id.*
160. *Id.*
161. *Id.*
162. *Id.*
163. *Our Role*, NASAA.ORG, http://www.nasaa.org/about-us/our-role/ (last visited June 2, 2012).
164. *Id.*
165. *About the Financial Industry Regulatory Authority,* FINRA.ORG http://www.finra.org/AboutFINRA/P125239 (last visited June 2, 2012).

enforcing rules, enforcing federal securities laws, educating investors, and administering a dispute resolution forum.[166] These functions are nearly identical to the functions performed, at the state level, by state regulators.

The SEC is charged with interpreting federal securities laws, issuing and amending rules, overseeing regulatory organizations, and coordinating U.S. securities regulation with federal, state, and foreign authorities.[167] The SEC also provides investor education materials.[168] Again, these roles are virtually identical to the functions performed by FINRA and state regulators.

In a post National Securities Markets Improvement Act of 1996 ("NSMIA") universe, state securities regulators have pursued the perpetrators at the local level who are scheming against "mom and pop" investors.[169] In turn, the SEC was expected to focus on the larger, more complex fraudulent activities undermining the securities market at a national level.[170] Nevertheless, states have "exposed and addressed the conflicts of interest among Wall Street stock analysts by requiring changed behavior."[171] From 2004 until 2009, state securities regulators conducted nearly 14,000 enforcement actions which led to $8.4 billion ordered returned to investors.[172] Additionally, during this period state regulators worked to secure convictions for securities laws violators resulting in more than 6,000 years in prison.[173]

IV. THE CURRENT DEBATE: AN SRO FOR INVESTMENT ADVISERS?

Over 11,000 investment advisers are currently registered with the SEC. As of September 30, 2010, these advisers managed more than thirty-eight trillion dollars for more than fourteen million clients. To date, the SEC regulates those investment advisers with assets under management (AUM) of twenty-five million dollars and over, while the state securities

166. *About the Financial Industry Regulatory Authority,* FINRA.ORG, http://www.finra.org/AboutFINRA/ (last visited June 2, 2012).

167. *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC.GOV, http://www.sec.gov/about/whatwedo.shtml (last visited June 2, 2012).

168. *Office of Investor Education and Advocacy*, SEC.GOV, http://www.sec.gov/investor.shtml (last visited June 2, 2012).

169. *Enhanced Investor Protection After the Financial Crisis: Hearing Before the S. Comm. On Banking, Housing, and Urban Affairs*, 112th Cong. 3 (2011) (statement of David Massey, President, North American Securities Administrators Association).

170. *Id.*

171. *Id.*

172. *Id.* at 2.

173. *Id.*

regulators regulate Investment Advisers with AUM up to that threshold.[174] This amount was increased to one hundred million dollars under section 410 of the Dodd-Frank Act, effective in 2012.[175]

In 2010, SEC Chairman Mary Schapiro testified to Congress that the Commission would be able to examine only about nine percent of registered investment advisers during the 2011 fiscal year. This statistic has led some to argue that an SRO should be created for investment advisers.[176] FINRA has made it clear that it would like to assume this mantle. In the first quarter of 2011, FINRA spent $300,000 to lobby Congress on issues including overtaking investment adviser oversight.[177]

In September of 2011, the House Subcommittee on Capital Markets and Government Sponsored Enterprises vetted draft legislation granting the SEC authority to register one or more SRO's for the regulation of investment advisers.[178] It is interesting to note that the investment adviser industry is almost universally opposed to an SRO, particularly if that SRO is FINRA.[179]

SUGGESTIONS AND CONCLUSIONS

In a perfect world, regulation would be conducted by wholly independent regulators. Regulators would be accountable to the investing public; likewise, their actions and decisions would be transparent to the public. Regulators would not be paid, nor would their leaders be elected by those they regulate. Those they regulate—be they brokerage firms, brokers, investment advisers or their representatives—would enjoy the same constitutional protections afforded to anyone subject to government investigation or prosecution.

Obviously, we do not live in a perfect world. For valid reasons,

174. *Investment Advisers: What You Need to Know Before Choosing One*, SEC.GOV, http://www.sec.gov/investor/pubs/invadvisers.htm (last visited June 2, 2012); *The Role of State Securities Regulators*, NASAA.ORG, http://www.nasaa.org/about-us/our-role/ (last visited June 2, 2012).

175. Dodd-Frank Wall Street Reform and Consumer Protection Act § 410, 15 U.S.C. § 80b-3a(a) (2012).

176. Stephen Luparello, FINRA Vice Chairman, Remarks at FSI Advocacy Summit (Oct. 5, 2011), *available at* http://www.finra.org/Newsroom/Speeches/Luparello/P124599.

177. Leondis & Faux, *supra* note 125.

178. Kristen French & Diana Britton, *House Proposes Bill That Would Give SROs Oversight of Investment Advisers*, REGISTERED REP, Sept. 8 2011, http://registeredrep.com/advisorland/regulatory/house_bill_sro_investment_advisers_0908/.

179. *Hearing on Regulation and Oversight of Broker-Dealers and Investment Advisers Before the H. Comm. on Financial Services*, 112th Cong. 4 (2011) (statement of David G. Tittsworth, Executive Director, Investment Adviser Association), *available at* http://financialservices.house.gov/UploadedFiles/091311tittsworth.pdf.

Congress enacted SRO legislation for securities regulation in 1938. Just as administrative agencies relieve Congress of overseeing complex matters beyond its expertise, SROs can relieve the SEC of the minutia of overseeing the membership of financial service providers in an increasingly complex financial world. In addition, as has been acutely demonstrated in recent years, it is expensive for the government to fund an agency the size of the SEC, and in the age of budget cuts and downsizing government, off-loading regulation to an SRO, which can be funded directly by its members, is an enticing alternative.

This debate is currently being played out in the halls of Congress, where the question is whether there should be SROs to regulate investment advisers and their representatives. Largely lost in this debate, however, is the issue of investor protection and relatedly, investor confidence. While opposed to the expansion of any SRO to the regulation of investment advisers, should such an expansion occur, we offer the following suggestions that would help to protect investors and restore their confidence in the financial markets. These suggestions are applicable to FINRA, in its current role as SRO for brokerage firms, and to any future SRO structure for investment advisers.

The "state actor" issue is problematic because it slows down the regulatory process by inhibiting sharing among regulators and the SRO. Also problematic is the fact that FINRA members are not afforded due process protections. FINRA and other SROs should give thought to abandoning the idea that they are not "governmental actors." If they have been delegated regulatory authority by the government and have rulemaking authority, they are in fact acting as the government, and due process (as well as the Freedom of Information Act) should apply. Should FINRA and other SROs choose to continue the role of a "private membership association," the current case law on the "state actor" issue does *not* warrant cessation of sharing between the SRO and a regulator, absent coercion or a joint investigation. Any SRO's sharing policy should be consistent with the current state of the law.

The funding of any SRO, and particularly the funding of its executive officers, correlates with the level of public confidence in the SRO. One possible way to combat the appearance of potential impropriety would be to change how FINRA is funded. Currently, FINRA charges fees to its members to garner the majority of its operating revenue. Instead, a portion of the federal securities regulation budget could be allocated to these activities. In that case, FINRA regulators would further shield against perceptions of undue influence. This insulation potentially would foster more aggressive regulation, which would help FINRA pursue its goal of effective investor protection. Alternatively, the inherent conflict of interest could be better managed if FINRA relinquished disciplinary control over its membership and turned enforcement matters back to the states, criminal authorities, and the SEC.

Likewise, the manner in which FINRA's leadership is elected can easily lead to the conclusion of "industry capture." To counter this inference, several approaches might be considered. First, FINRA could require a "sit-down period" for any industry professional hoping to join FINRA's regulatory leadership. The professional in question would be required to remove himself from the industry for a period of time before soliciting a position with FINRA. Additionally, FINRA could require that a certain percentage of its Board of Governors and executive leadership consist of consumer advocates and independent directors. Effective regulation should inspire investor confidence. Consumer advocates should have a voice in FINRA's leadership in order to ensure that investor protection is a constant priority. Again, alternatively, ceding control over enforcement matters could also serve to better insulate FINRA from outside criticism of its structure.

FINRA's arbitration system does not inspire investor confidence. First, it is compulsory. The Supreme Court has ruled that the arbitration provision is a binding contract;[180] however, FINRA could institute rulemaking that would prohibit mandatory arbitration provisions. Customers would then have a choice between arbitration and litigation. Second, the belief that arbitration is not played on a level field is well-supported. While we applaud the recent FINRA rule allowing customers to choose an all "public" panel, we would urge greater transparency in how arbitrators are classified as "public" or "industry" and how they are selected for particular cases.[181] In the alternative, even if FINRA continues to maintain control over all of its other areas (such as enforcement) in its effort to be a full service regulator, to make the arbitration process appear more independent, FINRA could collaborate with another organization to manage the arbitration process. Removing the dispute resolution process from FINRA's jurisdiction would add to the legitimacy and credibility of the arbitration process. Additionally, FINRA, in collaboration with the SEC and state regulators, could create a system for appellate review of arbitration decisions.

FINRA should be answerable to the appropriate governmental regulators, not the other way around, as both a legal matter and as a matter

180. Shearson/American Express Inc. v. McMahon, 482 U.S. 220, 242 (1987).

181. *See* FINRA R. 12403(a), (b), and (d) (FINRA 2010), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4141 (providing customers in cases with three arbitrators to choose between two selection methods).

of fact. The recent *Fiero* case highlights the need for greater oversight of FINRA's rulemaking.[182] Certainly, one cannot lay blame on FINRA if the SEC does not exercise its oversight authority. At the same time, the SEC cannot be faulted if it is not afforded the resources to effect such oversight.

Self-regulation of the retail securities markets in the United States, in conjunction with government led regulation, has brought about many positive results for investors. FINRA operates the largest investor education foundation in the United States.[183] Since its inception in 2003, the foundation has approved approximately fifty million dollars in investor education and protection initiatives through a combination of grants and targeted projects.[184] FINRA hosts conferences, training events, compliance boot camps, online learning programs, and the FINRA Institute at the Wharton School of the University of Pennsylvania.[185]

Likewise, as the BCG Study found, SROs may offer a "greater technical expertise because of their proximity to the industry," and that once a regulatory framework is in place, "self-regulators could monitor the industry more efficiently than government regulators."[186]

However, as discussed above, it is time for continued re-evaluation of our system at the core.[187] Although it appears in the short term that FINRA will continue to garner power and influence in the American retail securities markets, Congress and American leadership at the federal and state levels must consider the longer-term implication of allowing SROs to aggrandize authority and power. It is the retail consumer in the United States, the middle class investor, and the vast number of ordinary Main Street Americans that, in substantial part, demand power in the global economy. If this dynamic is to continue, as well as a paradigm of self-regulation, adding credibility to the self-regulatory system is imperative. As Michael Smallberg, an investigator with the Project on Government Oversight, recently put it: "[g]iving more authority to FINRA should come with additional transparency and accountability" because a "façade of a really robust examination or investigation process" will provide a "false

182. 660 F.3d 569 (2d Cir. 2011).

183. *About the Financial Industry Regulatory Authority,* FINRA, http://www.finra.org/AboutFINRA (last visited June 2, 2012).

184. *Id.*

185. *Education*, FINRA, http://www.finra.org/Industry/Education (last visited Apr. 7, 2012).

186. BOSTON CONSULTING GROUP, *supra* note 82, at 82.

187. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), while robustly comprehensive, addresses gaps in regulation of products and gaps in areas of securities regulation. Our view of the Dodd-Frank Act is that the all-consuming economic pressures of the recession beginning in 2008 caused Congress and the regulatory community to focus on those gaps rather than to include a re-examination of the overall existing structure of the American securities regulatory system.

sense of confidence for investors."[188]

Notwithstanding, the American near-term reliance on expanding a self-regulation system stands in sharp contrast to what our respected counterparts in Europe are doing with their financial regulatory systems. Europe has eschewed self-regulation in favor of more government-controlled regulation across the continent. The European community is not giving more responsibility and control to the industry that created the recession of 2008; rather, it is eliminating financial self-regulators (as in Britain, for instance), and moving to a more government-centric regulatory system for the financial markets.[189] Congress should be hard pressed to continue on the path of self-regulation when its foreign counterparts are moving in the opposite direction, given the ostensible interrelatedness of our economies, highlighted by the effects on the domestic capital markets of the debt crisis in Europe.

The multi-dimensional American system of regulation is truly one-of-a-kind. As the normative solutions presented in this Article suggest, our retail securities regulatory structure could stand to significantly improve efficiency, decrease compliance costs, and elevate cooperation among regulators in both national and international senses. An open mind to such improvements, and leadership in seeing them to speedy fruition, would enhance both investor safety and investor confidence.

188. *Finra Oversight Could Cost Investors*, *supra* note 83.

189. In terms of creating a global system for financial regulation to improve world-wide securities markets and to support capital building enterprises, the United States Chamber Commission on the Regulation of U.S. Capital Markets in the 21st Century, in its Summer 2011 report entitled, "U.S. Capital Markets Competitiveness: The Unfinished Agenda," is concerned about global disharmony in the capital markets space. The authors state:

> We still have the same old system—only more of it. We still have an inexplicable structure with multiple federal, state, and nongovernmental regulators, which often have overlapping jurisdictions and . . . conflicting regulations on similar activities, products, and services. . . . [T]here is no clear plan or strategy to address these fundamental problems . . . [and] foreign regulators have told us they will not follow our lead.

MICHAEL J. RYAN, JR., U.S. CHAMBER OF COMMERCE, U.S. CAPITAL MARKETS COMPETITIVENESS: THE UNFINISHED AGENDA 1 (2011), *available at* http://www.uschamber.com/sites/default/files/reports/1107_UnfinishedAgenda_WEB.pdf. While this Article focuses on improving the American regulatory system for investor protection, it is interesting to note that the Chamber of Commerce identifies similar issues for capital formation and global leadership in the financial capital markets.