

THE DARK SIDE OF SELF-REGULATION

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The financial services industry indirectly regulates itself through little-discussed, scandal-prone, and structurally-entrenched self-regulatory organizations. FINRA, the most prominent of these self-regulatory organizations, makes regulations and sets enforcement policy that directly affect public welfare. As with other self-regulatory organizations, FINRA's structure poses a continual risk that industry members will subvert its processes to act like a cartel, promoting industry interests at the expense of the public and contributing to the excessive rents collected by financial intermediaries. Although this dark side to self-regulation poses a constant danger, structural reforms may increase the likelihood that FINRA and other self-regulatory organizations will take the public's interests into account. While others have discussed how self-regulatory organizations increasingly resemble a fifth branch of the federal government, this article shifts the focus to how the public actually exercises its voice within FINRA and other self-regulatory organizations.

This Article examines the purportedly public representatives serving on FINRA's Board of Governors. It finds that these public representatives often simultaneously serve on the boards of corporate financial intermediaries, giving rise to conflicts of interest between loyalties to market participants and industry lobbying groups and their roles as protectors of the public interest. To amplify the public's voice within these organizations, this Article proposes a different appointment process for the public representatives serving within self-regulatory organizations and calls for increased transparency and improved oversight.

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I. INTRODUCTION

“Just why the [National Association of Securities Dealers (NASD)] had created a playing field that so clearly fucked over the customer was something I’d thought about often, and I’d come to the conclusion that it was because the NASD was a self-regulatory agency, “owned” by the very brokerage firms themselves. (In fact, Stratton Oakmont was a member too.)”

– Jordan Belfort, *The Wolf of Wall Street*¹

Governance structures influence institutional behavior. Organizational priorities and focus often depend on how an organization selects its leadership. This remains true for business entities, governmental organizations, and the odd creatures that lurk in between.

The Financial Industry Regulatory Authority (FINRA), formerly known as the National Association of Security Dealers (NASD), is a quasi-governmental organization in the liminal space between business and government.² It serves as primary regulator for Wall Street’s broker-

1. JORDAN BELFORT, *THE WOLF OF WALL STREET* 99 (2013).

2. FINRA describes itself as “an independent, not-for-profit organization authorized by Congress to protect America’s investors by making sure the securities industry operates fairly and honestly.” *About*

dealer firms, and its rules and regulations contour much of the investor protection landscape. Broker-dealer firms elect representatives to FINRA's Board of Governors, allowing the industry to regulate itself with limited public oversight. To protect the public and counterbalance industry influence, FINRA's bylaws also call for a majority of its Board of Governors be "public" members.³ In theory, including public representatives on FINRA's governing board should ensure that the organization appropriately balances the public's interest against the industry's legitimate operational concerns.

Public representatives play an important role. They influence the self-regulator's zeal to protect investors. FINRA's bylaws call for Public Governors to have no "material business relationship" to "a broker or dealer or [other] self regulatory organization."⁴ Although the bylaws do not define the term "material business relationship," its practices show a tolerance for public members with significant connections to the financial services industry.⁵ Many of FINRA's public governors have had long industry careers and serve on the boards of other financial services firms.⁶ While these backgrounds may increase the likelihood that public representatives understand issues, this benefit comes with a dark side—the risk that public representatives will naturally sympathize with industry more than public concerns.

Illustrating this concern, one "public" governor also serves on the board of an industry-funded organization that actively lobbies on behalf of the industry. FINRA's annual report identifies Randal Quarles as a current "public" governor.⁷ Mr. Quarles also serves on the Board of

FINRA, FINRA, <http://www.finra.org/about> (last visited July 6, 2016). Some controversy exists over whether FINRA has become a de facto extension of the government. See Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. 151 (2008) ("This article addresses the questions of whether, and to what extent, securities industry [self-regulatory organizations] have become government agencies, and whether, and to what extent, they should be subject to constitutional and statutory controls on government agencies") [hereinafter Karmel, *Government Agencies?*]; William A. Birdthistle & M. Todd Henderson, *Becoming A Fifth Branch*, 99 CORNELL L. REV. 1 (2013) (arguing that FINRA may become a quasi-governmental organization).

3. FINRA, BY-LAWS OF THE CORPORATION ART. VII, § 4 ("The number of Public Governors shall exceed the number of Industry Governors.").

4. FINRA, BY-LAWS OF THE CORPORATION ART. I, § tt.

5. See Susan Antilla, *Finance Execs Fill 'Public' Board Seats at Finra, the Regulator That Promises Investor Protection*, STREET FOUND. (Aug. 26, 2016), <http://www.thestreetfoundation.org/story/finance-execs-fill-public-board-seats-finra-regulator-promises-investor-protection> (discussing industry connections of "public" representatives).

6. For a discussion of the industry ties of public representatives, see text accompanying notes 77–110.

7. FINRA, FINRA 2015 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT 65 (July 30, 2016), https://www.finra.org/sites/default/files/2015_YIR_AFR.pdf [hereinafter FINRA, 2015 ANNUAL REPORT].

Directors of the U.S. Chamber of Commerce (U.S. Chamber).⁸ The U.S. Chamber describes itself as the “world’s largest business organization representing the interests of more than 3 million businesses.”⁹ FINRA-regulated firms have contributed substantial sums to the U.S. Chamber.¹⁰ Serving these interests, the U.S. Chamber has filed a lawsuit attempting to block a proposed rule that would require many financial advisers to give advice in the best interests of their clients.¹¹

The composition of FINRA’s Board of Governors matters because it makes significant policy decisions that shape the industry and influence the public costs associated with financial services. These same public costs are revenues to FINRA’s member firms, however, so the FINRA may not rush to support changes that would reduce overall costs. In any event, the costs of financial intermediation have remained puzzlingly high. One recent study by Thomas Philippon found that “the unit cost of intermediation is about as high today as it was at the turn of the 20th century.”¹² This is particularly puzzling because improvements in information technology “should lower the physical transaction costs of buying, pooling and holding financial assets.”¹³

These issues diminish public confidence in FINRA’s independence by making it possible for detractors to reasonably characterize its majority public board as “captured” by industry. Ultimately, FINRA’s legitimacy and efficacy depend on its ability to protect the public’s interest while drawing on industry expertise and balancing industry concerns.¹⁴ The industry’s control over its own regulation cannot be justified if the industry uses that power to create a cartel supporting wealth transfers from investors to industry firms.¹⁵

8. See *Board of Directors*, U.S. CHAMBER COMMERCE, <https://www.uschamber.com/about-us/board-directors> (last visited July 6, 2016).

9. *About the U.S. Chamber*, U.S. CHAMBER COMMERCE, <https://www.uschamber.com/about-us/about-the-us-chamber> (last visited July 6, 2016).

10. For example, in 2014, Prudential Financial contributed \$185,000 to the U.S. Chamber with \$75,000 earmarked for lobbying. *2014 Political Activities and Contributions Report*, PRUDENTIAL 21 (Apr. 2015), http://www.prudential.com/media/managed/public/PAC_Annual_Report_14-Final.pdf.

11. See text accompanying note 107.

12. Thomas Philippon, *Has the U.S. Finance Industry Become Less Efficient? On the Theory and Measurement of Financial Intermediation*, 105 AM. ECON. REV. 1408, 1413 (2015) [hereinafter Philippon, *Less Efficient*].

13. *Id.* at 1434 (“A potential explanation is oligopolistic competition but the link between market power and the unit cost of intermediation is not easy to establish.”).

14. See Sam Scott Miller, *Self-Regulation of the Securities Markets: A Critical Examination*, 42 WASH. & LEE L. REV. 853, 855 (1985) (explaining that through self-regulation the “regulators and the regulated seek different objectives” with regulators seeking efficient oversight and industry seeking cheaper regulation) [hereinafter Miller, *Self-Regulation*].

15. See Birdthistle & Henderson, *supra* note 2, at 12 (“Self-regulation is easily justified if it protects investors and maximizes social welfare but may not be if it is used merely to transfer wealth from investors to brokers. This ‘cartelization’ problem is present in almost every area of broker-dealer

To amplify the forces driving FINRA and other self-regulatory organizations to act in the public's interest, this Article argues for structural reforms to the regulatory architecture.¹⁶ These reforms seek to address the problem from three different angles: the inside, the outside, and above. To apply pressure from the inside, public processes should pick the purportedly public members serving on FINRA's Board of Governors. The current system allows industry representatives to influence directly the selection of public representatives, increasing the risk that these purportedly "public" representatives possess industry-aligned views and sympathies.¹⁷ To ensure outside monitoring and accountability, self-regulatory bodies wielding quasi-governmental power should be required to provide transparent access to information. This Article calls for expanding the Freedom of Information Act to allow the public to review the SEC's oversight of FINRA's operations. Public pressure might also constrain industry influence. Additional transparency might also be achieved by requiring FINRA to meet some of the disclosure requirements of publicly traded companies and to file public annual reports with the SEC. Finally, this Article argues that enhanced supervision from the SEC might unleash competitive forces and provide more meaningful pressure from above.

These reforms should not be viewed as silver bullets. Rather they may alter the competing forces driving FINRA's behavior and may cause it to act differently in some instances. These reforms will not entirely displace existing pressures for FINRA to act in ways that align poorly with the public interest. Still, these reforms should shift the internal equilibrium significantly, altering behavior in some instances. For example, amplifying the public's voice should reduce the instances when FINRA will act against the public interest and make its inevitable course corrections come more quickly. Similarly, increased transparency and access to information would let outside researchers and critics detect issues more quickly. It would also provide a deterrent against exploitative behavior by increasing the likelihood of discovery.

This Article tackles a substantial gap in the literature and addresses how to "nudge" FINRA and other self-regulatory bodies into protecting the public.¹⁸ While prior work has explored how the commission

regulation.").

16. A discussion of these reforms is available at the text accompanying notes 259 to 294.

17. This Article presents publicly available information demonstrating that a significant majority of FINRA's current board would not be deemed "Public" under its own rules for distinguishing between Public and Non-Public for arbitrators within its arbitration forum.

18. See Anita K. Krug, *Downstream Securities Regulation*, 94 B.U. L. REV. 1589, 1593 (2014) (explaining that "[s]ecurities law scholars have tended to assume that securities regulation, in all its forms, is ultimately reducible to the regulation of securities issuers, particularly the public kind" and generally neglected the regulation of financial services and broker-dealer firms).

compensation structure for financial advice causes the widespread misallocation of capital, this Article examines the regulatory structures that oversee the current system.¹⁹ Despite the clear need for effective supervision of the securities industry, the literature on “industry self-regulation” remains underdeveloped.²⁰ This Article contributes to the literature by focusing on FINRA’s governance structure and reforms that will create continual pressure to act in the public’s interest and counteract the industry’s incentive to tilt regulation toward higher-fee arrangements.²¹

This Article proceeds in five (II–VI) parts. Part II introduces FINRA’s unique history, role, and responsibilities. Part III discusses the public’s interest in financial regulation before Part IV critically examines traditional rationales for self-regulation. Part V suggests governance and policy reforms to increase FINRA’s independence from industry. Part VI discusses the implications of and challenges to this approach.

While this Article focuses on FINRA, its insights also have broader applicability. The principles developed here can be applied to other self-regulatory organizations to help create a more effective balance against the possible dark sides of self-regulation.

II. FINRA’S HISTORY, RESPONSIBILITIES, AND GOVERNANCE

While most now recognize administrative agencies as a fourth branch of government, FINRA and other financial self-regulatory organizations serve as a fifth branch and now play a vital role in financial regulation.²² This Part opens by presenting a case study of FINRA’s history, quasi-governmental status, role in investor protection, and governance.

A. *FINRA’s Unique History*

Wall Street’s self-regulation first emerged from the creation of a cartel

19. Benjamin P. Edwards, *Conflicts & Capital Allocation*, 78 OHIO ST. L.J. 181 (2017).

20. See Jonathan Macey & Caroline Novogrod, *Enforcing Self-Regulatory Organization’s Penalties and the Nature of Self-Regulation*, 40 HOFSTRA L. REV. 963 (2012) (“Few issues are as poorly understood and under-theorized as the concept of ‘industry self-regulation.’”); Andrew F. Tuch, *The Self-Regulation of Investment Bankers*, 83 GEO. WASH. L. REV. 101, 105 (2014) (explaining that FINRA’s “self-regulation of investment bankers has thus far attracted scant scholarly attention”); Saule T. Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 414–15 (2011) (“[W]hat is conspicuously absent from the . . . broader debate among academics and policy-makers, is a meaningful discussion of the role and shape of industry self-regulation in the emerging postcrisis regulatory order . . .”).

21. Kathryn Judge, *Intermediary Influence*, 82 U. CHI. L. REV. 573, 577 (2015) (“Because fees are revenue to the intermediaries to whom they are paid, intermediaries prefer laws, norms, market structures, and other institutional arrangements that entail higher, not lower, transaction fees.”).

22. See Birdthistle & Henderson, *supra* note 2.

attempting to control securities trading.²³ Cartelization occurs when firms join together to fix prices, restrict competition, or otherwise promote their interests through collective action. When cartels engage in self-regulation, they control member behavior to advance the collective interests of the cartel, rather than the interests of the public.²⁴

1. FINRA's Precursor: The New York Stock Exchange

FINRA traces its history back to 1792 when New York traders and brokers gathered underneath a buttonwood tree and negotiated an agreement to fix prices and trade with each other. Those present made a solemn vow not to “buy or sell . . . for any person . . . any kind of public stock at a rate less than one-quarter percent commission.”²⁵

The group of price-fixing traders that signed the famous “Buttonwood Agreement” later became the New York Stock Exchange Board (NYSE) in 1817.²⁶ Members of this cartel enjoyed fixed commission rates for executing securities trades and access to superior information.²⁷ To overcome the incentive to cheat the cartel by cutting prices and gaining market share, the NYSE began to pass rules to control member behavior. For example, a month after its founding, the NYSE instituted fines for members that left the room during auctions.²⁸

As growth continued, the NYSE became increasingly formal and

23. See JOHN C. COFFEE ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 690 (13th ed. 2015) (explaining that self-regulation's private enforcement originated out of “efforts at cartelization by brokers”). See also William F. Baxter, *NYSE Fixed Commission Rates: A Private Cartel Goes Public*, 22 STAN. L. REV. 675, 712 (1970) for a discussion of other forms of self-regulation. See also Saule T. Omarova, *Rethinking the Future of Self-Regulation in the Financial Industry*, 35 BROOK. J. INT'L L. 665, 674 (2010) (“[B]ecause the concept of self-regulation is both deceptively simple and heavily normatively loaded, it is worth examining its meaning and boundaries in some detail.”).

24. Cartels often struggle to control members that seek to profit by secretly breaking cartel rules. To more effectively enforce cartel discipline, some cartels seek government authorization to discipline their members. See Timothy J. Muris, *Principles for a Successful Competition Agency*, 72 U. CHI. L. REV. 165, 170 (2005) (“While cheating often undermines private cartels, those who cheat on public cartels, once identified, can be sanctioned through the government.”).

25. *The Institution of Experience: Self-Regulatory Organizations in the Securities Industry, 1792-2010: Rules of the Club, Protecting the Members and the Market*, SEC. & EXCH. COMM. HISTORICAL SOC'Y, <http://www.sechistorical.org/museum/galleries/sro/sro02b.php> (last visited July 6, 2016) [hereinafter *SEC History, Protecting Members*]. The members also promised to give preferences to cartel members over nonmembers in negotiations. *Id.*

26. Jill Gross, *The Historical Basis of Securities Arbitration as an Investor Protection Mechanism*, 2016 J. DISP. RESOL. 171, 174 (2016) (citing FRANCIS L. EAMES, *THE NEW YORK STOCK EXCHANGE* 13 (1894)).

27. See *SEC History, Protecting Members*, *supra* note 25 (“Members enjoyed the advantages of participating in an industry cartel that continued to regulate commission rates.”).

28. *Id.* A member that left the room would know the price and could execute trades outside at the NYSE market price.

introduced its own internal legal system to regulate member behavior.²⁹ From the start, this legal system focused on enforcing cartel discipline by cracking down harshly on members that violated the minimum commission rules.³⁰ Enforcement actions for swindling customers were rare.³¹

The trend continued into the early 20th century with revelations that the NYSE took no action despite knowing that its members routinely manipulated securities by trading through stock pools. Stock pools manipulate prices by trading with each other to give the impression of genuine market demand, which drives prices higher. When investors bought into the pool, anticipating further appreciation, pool members would dump the stock. This left investors with losses after the artificially created demand evaporated.³² Traders employing stock pools sat on the NYSE's governing committee, and the NYSE's failure to act has been attributed to their presence.³³ Despite this, the NYSE publicly advertised itself as acting in "the public interest," claiming that members participating "in market raids may be disciplined."³⁴

Industry self-regulation, in other words, failed to adequately protect the public from unrestrained manipulation and deception in the stock market. This unrestrained manipulation and deception proliferated before the 1929 crash and contributed to the Great Depression.³⁵ In his inaugural address, President Franklin D. Roosevelt told the crowd that "the rulers of the exchange of mankind's goods have failed" and promised to deliver

29. See *Belton v. Hatch*, 17 N.E. 225 (N.Y. 1888) (finding that the NYSE could validly discipline its members by expelling them from the organization).

30. *The Institution of Experience: Self-Regulatory Organizations in the Securities Industry, 1792-2010: Rules of the Club, Coherence of the Self-Regulatory Regime*, SEC. & EXCH. COMM. HISTORICAL SOC'Y, <http://www.sechistorical.org/museum/galleries/sro/sro02c.php> (last visited July 6, 2016) ("From the first, however, this member-controlled regime inevitably favored the floor over the investors that it served, particularly in enforcement.").

31. *Id.*

32. See MICHAEL PERINO, *THE HELLHOUND OF WALL STREET: HOW FERDINAND PECORA'S INVESTIGATION OF THE GREAT CRASH FOREVER CHANGED AMERICAN FINANCE* 267-68 (2010) (explaining how stock pools manipulated market prices).

33. See *The Institution of Experience: Self-Regulatory Organizations in the Securities Industry, 1792-2010: Rules of the Club, Public Relations and Partial Reforms*, SEC. & EXCH. COMM. HISTORICAL SOC'Y, <http://www.sechistorical.org/museum/galleries/sro/sro02e.php> (last visited July 6, 2016) ("[T]he real power at the NYSE—the governing committee—was dominated by the floor traders and specialists who considered pools to be prerequisites of the trade.").

34. H.S. MARTIN, *THE CONSTITUTION OF THE NEW YORK STOCK EXCHANGE* 9-10 (Dec. 3, 1925).

35. Debate continues about the precise cause of the Great Depression, but manipulative market practices certainly contributed. See Steven A. Ramirez, *The Law and Macroeconomics of the New Deal at 70*, 62 MD. L. REV. 515, 526-27 (2003) ("The genesis of the Depression had its roots in the speculative stock market boom of the 1920s."); Jorge Pesok, *Insider Trading: No Longer Reserved for Insiders*, 14 FLA. ST. U. BUS. REV. 109, 111 (2015) (explaining that Congress passed the federal securities laws "in response to the manipulation and deception that plagued the stock market in the 1920s and eventually caused the Great Depression.").

comprehensive reform to restrain future manipulation and deception.³⁶

2. Increased Oversight: Breaking Out the SEC's Shotgun

Wall Street's self-regulatory organizations fought to keep their independence and predicted financial ruin if proposed reforms were implemented.³⁷ Richard Whitney, then-president of the NYSE, predicted that federal oversight of the NYSE and other stock exchanges would “‘destroy the free and open market for securities’ and turn Wall Street into ‘a deserted village.’”³⁸ The head of the Association of Stock Exchanges claimed that proposed legislation would cure “a case of hiccups by ‘severing the head of the patient.’”³⁹

Despite intense opposition from the NYSE and Wall Street generally, federal legislation came with the Securities Act of 1933 (Securities Act)⁴⁰ and the Securities Exchange Act of 1934 (Exchange Act).⁴¹ With the Exchange Act, Congress created the SEC and charged it with overseeing the NYSE and other self-regulating securities exchanges.⁴²

Former SEC Chairman and later Supreme Court Justice William O. Douglas joined the SEC as staff, shortly after its creation.⁴³ During his tenure at the SEC, he sought “first to make the management of the [NYSE] less like that of a club and more like that of a public institution; and second, to revise all the rules necessary to take away the insider's advantage over the public.”⁴⁴

Federal oversight of Wall Street through self-regulatory associations relies on vigilant oversight. Douglas described the SEC's initial oversight role as “letting the exchanges take the leadership with Government

36. PERINO, *supra* note 32, at 3.

37. Financial intermediaries have a long history of predicting disaster to forestall reforms. *See, e.g.,* Judge, *supra* note 21, at 597 (“By highlighting potential drawbacks . . . the securities industry sought to influence SEC decisionmaking . . . faced with a choice between a system known to work . . . and one about which there were inevitable uncertainties, it would have been difficult—and irrational—for the SEC to entirely ignore the industry's dire predictions.”).

38. PERINO, *supra* note 32, at 293.

39. *See id.* at 292–93 (explaining that Wall Street and the NYSE argued that passing securities laws would undermine economic recovery because issuers would fear liability so much that they would forego offerings).

40. 15 U.S.C. §§ 77a–77aa. (2012).

41. 15 U.S.C. §§ 78a–78pp (2012).

42. *See* Silver v. N.Y. Stock Exch., 373 U.S. 341, 351–52 (1963) (“It was, therefore, the combination of the enormous growth in the power and impact of exchanges in our economy, and their inability and unwillingness to curb abuses which had increasingly grave implications because of this growth, that moved Congress to enact the Securities Exchange Act of 1934.”) (emphasis added).

43. WILLIAM O. DOUGLAS, GO EAST, YOUNG MAN: THE EARLY YEARS: THE AUTOBIOGRAPHY OF WILLIAM O. DOUGLAS 258 (1974).

44. *Id.* at 291 (claiming that the self-regulating exchanges had become “modern Augean stables . . . fighting for opportunities to exploit the unsuspecting public”).

playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.”⁴⁵

The NYSE slowly began to adapt under new SEC oversight. For example, on the same day the NYSE Board voted to expel Richard Whitney for embezzling money from a trust fund for widows and orphans, it approved a committee recommendation to add three public members to its thirty-person board.⁴⁶ Thus, the inclusion of purportedly public representatives on self-regulatory organization boards began. Shortly thereafter, one of these first public members resigned when the NYSE Board declined to expel members that had knowingly tolerated Whitney’s embezzlement.⁴⁷

In 1938, the shotgun-toting SEC assumed additional oversight responsibilities with the passage of the Maloney Act of 1938.⁴⁸ The Maloney Act sought to aid the SEC’s supervision of over-the-counter markets by requiring broker-dealer firms to join together for cooperative self-regulation through voluntary associations.⁴⁹ The previously unregulated over-the-counter market included broker-dealer firms trading stocks outside of the limited oversight provided by the existing self-regulating exchanges. By design, the Maloney Act contemplated the creation of a self-regulatory association that would serve as both a regulator and a professional organization for the over-the-counter market.⁵⁰ The SEC only authorized one self-regulatory organization, the NASD, which merged with the regulatory arm of the NYSE in 2007 to create FINRA.⁵¹

45. WILLIAM O. DOUGLAS, *DEMOCRACY AND FINANCE: THE ADDRESSES AND PUBLIC STATEMENTS OF WILLIAM O. DOUGLAS AS MEMBER AND CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION* 82 (James Allen ed., 1940).

46. *Id.* at 291; PERINO, *supra* note 32, at 296 (“Whitney lifted bonds and cash from the stock exchange’s Gratuity Fund, a trust for the widows and orphans of exchange members.”).

47. DOUGLAS, *supra* note 43, at 291–92 (explaining that an SEC investigation “revealed the names of various Exchange members who knew of Whitney’s wrongdoing before the news broke. But nothing was ever done by the Exchange to discipline or censure any of these members”).

48. 15 U.S.C. § 78o-3 (2012). For a description of the Maloney Act’s framing, see *The Institution of Experience: Self-Regulatory Organizations in the Securities Industry, 1792-2010: Born Regulated, Self Help and the New Deal*, SEC. & EXCH. COMM. HISTORICAL SOC’Y, <http://www.sechistorical.org/museum/galleries/sro/sro04b.php#ftn49> (last visited July 6, 2016) (“Whereas the Exchange Act had created a new self-regulatory model that enveloped the NYSE and the regional exchanges into a scheme of federal securities regulation, the Maloney Act extended that model to entities other than exchanges.”).

49. *Id.*; see also DOUGLAS, *supra* note 43, at 271 (explaining that the Exchange Act “was amended to allow, under general supervision of the commission, the self-government of brokers and dealers on the over-the-counter market (which we facetiously called the under-the-counter market)”).

50. See Karmel, *supra* note 2, at 160–61 (“From its inception, the NASD was a peculiar body, designed to act as a regulator, but also functioning as a professional organization.”).

51. Tuch, *supra* note 20, at 112; Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975, 1023 (2005) (“[T]he NASD owes

B. FINRA's Unique Status and Role

At present, the federal regulatory scheme for the securities industry depends heavily on industry regulating itself through self-regulatory associations.⁵² As the largest self-regulatory association and the only self-regulatory association for broker-dealer firms, FINRA now oversees a tremendous volume of activity. One recent annual report reveals that it “processes and monitors on average 50 billion—and up to 75 billion—pieces of market data every day.”⁵³

1. Quasi-Governmental Status

FINRA straddles the line between a public and private entity. Although FINRA officially remains a private, not-for-profit corporation, it plays such an integral—and increasingly governmental—role in securities regulation that debates have emerged over whether it should be classified as a state actor.⁵⁴ The literature and case law frequently describe it as a quasi-governmental organization.⁵⁵

In many respects, FINRA often enjoys perquisites normally reserved for state actors.⁵⁶ For example, it enjoys absolute immunity for its regulatory functions and even actions that are “incident to” its regulatory functions, such as amending its bylaws.⁵⁷ It also enjoys a form of taxing power, having the ability to raise money by imposing fees on member firms.⁵⁸ The Exchange Act authorizes FINRA to discipline its members

its origins to a trade group founded in 1912 by several investment banks, the Investment Bankers Association of America . . .”).

52. See Barbara Black, *Punishing Bad Brokers: Self-Regulation and FINRA Sanctions*, 8 BROOK. J. CORP. FIN. & COM. L. 23, 23 (2013) (“Regulation of the broker-dealer industry by a self-regulatory organization (SRO) is an integral part of the federal regulatory scheme.”).

53. FINRA, 2015 ANNUAL REPORT, *supra* note 7, at 1.

54. See Birdthistle & Henderson, *supra* note 2, at 13 (“These particular SROs are becoming or, as some have argued, have become quasi-governmental organizations (QGO).”).

55. See, e.g., Jennifer M. Pacella, *If the Shoe of the SEC Doesn't Fit: Self-Regulatory Organizations and Absolute Immunity*, 58 WAYNE L. REV. 201, 202 (2012) (“SROs carry out quasi-governmental functions as delegates of the SEC.”); *Nat'l Ass'n of Sec. Dealers, Inc. v. S.E.C.*, 431 F.3d 803, 804 (D.C. Cir. 2005) (the NASD “serves as a quasi-governmental agency”). Roberta Karmel characterizes self-regulatory associations as a “peculiar mix of private sector self-regulation and delegated governmental regulation.” Karmel, *supra* note 2, at 151.

56. See Kenneth B. Orenbach, *A New Twist to an On-Going Debate About Securities Self-Regulation: It's Time to End FINRA's Federal Income Tax Exemption*, 31 VA. TAX REV. 135, 194 (2011) (“Although FINRA is not a government agency for constitutional purposes, it has many of the attributes of a government agency and it functions as if it were such an agency.”).

57. See *Standard Inv. Chartered, Inc. v. Nat'l Ass'n of Sec. Dealers*, 637 F.3d 112, 114–15 (2d Cir. 2011), *cert. denied*, 565 U.S. 1173 (2012).

58. See, e.g., Dan Jamieson, *FINRA Aims to Hike Fees Due to 'Significant Loss'*, INVESTMENTNEWS (Apr. 24, 2012), <http://www.investmentnews.com/article/20120424/FREE/120429962/finra-aims-to-hike-fees-due-to->

for violating its own rules, the Exchange Act or SEC rules.⁵⁹ Despite this, the extent of its enforcement power remains limited, and it may only discipline members by “expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction.”⁶⁰ It lacks jurisdiction over nonmembers or the ability to impose criminal liability. Importantly, while FINRA enjoys the protection of absolute, quasi-sovereign immunity for its regulatory functions, its obligation to provide due process protections remains unsettled.⁶¹

2. Investor Protection

FINRA’s rules shape investor rights by setting out the duties that broker-dealers owe to their customers. Some of these rules seem more aspirational than substantive. For example, FINRA’s rules require its members to “observe high standards of commercial honor and just and equitable principles of trade.”⁶² The substantive content of this requirement remains unclear. Other FINRA rules specify the obligations many financial advisers actually owe their clients, such as the much-criticized “suitability” rule,⁶³ which allows financial advisers to sell clients “suitable” investments even if they are not necessarily in their client’s best interests.⁶⁴

FINRA also polices the behavior of broker-dealer firms through enforcement actions. It explains that one of its “top priorities is to advance investor confidence in the securities markets through vigorous,

significant-loss (detailing a FINRA fee hike).

59. 15 U.S.C.A. § 78o-3(b)(7) (2012).

60. *Id.*

61. *Compare* D’Alessio v. S.E.C., 380 F.3d 112, 120 n.12 (2d Cir. 2004) (“[T]he National Association of Securities Dealers (‘NASD’), a private SRO . . . is not a state actor subject to due process requirements.”), *with* Rooms v. S.E.C., 444 F.3d 1208, 1214 (10th Cir. 2006) (“Due process requires that an NASD rule give fair warning of prohibited conduct before a person may be disciplined for that conduct.”). For a detailed discussion of the due process decisions, see Jerrod M. Lukacs, *Much Ado About Nothing: How the Securities SRO State Actor Circuit Split Has Been Misinterpreted and What It Means for Due Process at FINRA*, 47 GA. L. REV. 923, 959 (2013) (“[W]hether FINRA is a private or public actor remains tied up in a complicated split among the circuit courts.”).

62. FINRA, FINRA MANUAL, R. 2010 (2008).

63. FINRA, FINRA MANUAL, R. 2011 (2014).

64. *See* Christine Lazaro, *Fiduciary Duty - Now and in the Future*, 17 PIABA B.J. 129, 132 (2010) (“[T]he suitability standard requires that a recommendation merely be suitable for a customer, not necessarily that it be in the customer’s best interest.”); Patricia A. McCoy, *Degrees of Intermediation*, 50 WAKE FOREST L. REV. 551, 571 (2015) (“Because the duty of suitability is not a fiduciary duty, securities brokers are not required to act in their clients’ best interests or diversify their portfolios Nor must brokers avoid recommending investments that will maximize their fees if their advice is suitable otherwise”).

fair and effective enforcement” of its own rules and the securities laws.⁶⁵ Others have explained that financial self-regulatory organizations may be able to enforce effectively so long as they are “maintaining a monopoly and using their credible threat to be able to exclude a participating firm from the cartel as its ultimate enforcement mechanism.”⁶⁶

3. Dispute Resolution

FINRA also maintains control over industry regulation and the extent of investor protection available by channeling customer disputes through its arbitration forum.⁶⁷ Unlike traditional court cases, arbitration awards do not create binding precedent and generally do not set forth any rationale for the decision.⁶⁸ Given the lack of explanation or precedent, determining the actual level of investor protection provided by FINRA’s arbitration process may be impossible.⁶⁹

FINRA’s arbitration process may undercut investor protection by diminishing the ability of courts to refine existing obligations to account for changed circumstances. With nearly all customer disputes flowing through arbitration, courts resolve customer disputes only in rare instances. This means that the law likely changes at a much slower pace than the market evolves, rather than if courts were continually grappling with new financial products and strategies.

C. Mixed Industry and Public Governance

FINRA’s governance structure and the voices it empowers undoubtedly influence its culture and behavior. FINRA’s bylaws call for a majority public board. It contains twenty-three members, with nine industry representatives, thirteen purportedly public members, and FINRA’s CEO.⁷⁰

A key premise underlies the decision to appoint to the board public representatives, who must bring something different to the board than

65. *Enforcement*, FINRA, <http://www.finra.org/industry/enforcement> (last visited Aug. 16, 2016).

66. Macey & Novogrod, *supra* note 20, at 966 (explaining that FINRA must maintain market power to exercise effective discipline).

67. Most broker-dealers require customers to sign arbitration agreements that force customers to resolve their disputes out of court. See *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 226 (1987) (“The Arbitration Act . . . mandates enforcement of agreements to arbitrate statutory claims.”).

68. See Barbara Black & Jill I. Gross, *Making It Up as They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 992 (2002) (“[A]wards do not serve as precedent—future arbitration panels cannot rely on previous awards as a source of authority.”).

69. Mercer Bullard, *The Fiduciary Study: A Triumph of Substance over Form?*, 30 REV. BANKING & FIN. L. 171, 179 (2010) (arguing that the standards actually applied in FINRA arbitration may be unknowable).

70. FINRA, 2015 ANNUAL REPORT, *supra* note 7, at 65.

industry members—otherwise their appointment would serve no purpose. Ideally, public representatives zealously guard the public's interest and counterbalance industry influence within self-regulatory organizations. To achieve this ideal, a public representative must have actual independence and a true public-interest orientation. If, however, public representatives share the same perspectives, beliefs, and biases as industry members, they may represent the public's interest with less vigor.⁷¹ At worst, industry-aligned public representatives provide only a veneer of publicness, cloaking industry domination over a purportedly independent board.

Despite the importance of good governance, the SEC has devoted little attention to overseeing FINRA's governance processes. A 2012 Government Accountability Office Report found that the SEC had "conducted limited or no oversight of . . . FINRA's . . . governance and executive compensation."⁷² More specifically, between 2005 and 2010, the SEC conducted no oversight of FINRA's transparency of governance.⁷³ With respect to FINRA's Board of Governors, the SEC told the Government Accountability Office that it "periodically reviewed the composition of FINRA's board to determine compliance with SRO board-composition requirements."⁷⁴ The SEC indicated that it had not "examined issues such as conflicts of interest or recusals related to FINRA's governance."⁷⁵

For these reasons, the SEC's oversight of FINRA's operations has been fairly criticized. To be fair, the SEC's task may have been made more challenging by repeated instances of FINRA officials providing "altered or misleading documents" to the SEC.⁷⁶ Still, its supervisory resources could likely be targeted more effectively. The following case study of FINRA's board shows that more extensive oversight of the "public" member appointment process might do substantial good.

71. See Steven Davidoff Solomon, *The Government's Elite and Regulatory Capture*, N.Y. TIMES (June 11, 2010), <http://dealbook.nytimes.com/2010/06/11/the-governments-elite-and-regulatory-capture> (explaining that ideological capture occurs when regulators "share the same beliefs and ideas as their industry").

72. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-625, SECURITIES REGULATION: OPPORTUNITIES EXIST TO IMPROVE SEC'S OVERSIGHT OF THE FINANCIAL INDUSTRY REGULATORY AUTHORITY 7 (2012).

73. *Id.*

74. *Id.* at 16.

75. *Id.*

76. See FINRA, Exchange Act Release No. 65643, 2011 WL 5097714, at *2 (ALJ Oct. 27, 2011) (order instituting cease-and-desist) ("FINRA employees have produced altered or misleading documents to Commission inspection staff on three separate occasions over the past eight years.").

1. FINRA's Non-Public Public Governors

FINRA's Board of Governors often includes former high-level industry executives as public representatives. In many instances, these public representatives would be deemed "non-public" under FINRA's own rules for its arbitration forum. For its board, FINRA merely requires that its "Public Governors" not have any "material business relationship" with a broker, a dealer, or other self-regulatory organization.⁷⁷ For arbitrators, however, FINRA clearly distinguishes between public and non-public persons for purposes of its arbitration forum. Unlike the vague materiality standard for board members, FINRA created bright lines for arbitrator classifications.⁷⁸ Notably, after years of criticism FINRA made it possible for customer claimants to have access to an all-public arbitration panel because of fears of pro-industry bias in the forum.⁷⁹

Such fears were well-founded; arbitrator background certainly influences outcomes for investor claimants. A recent empirical study of arbitration outcomes found, among other things, that "arbitrators with connections to the industry issue lower awards" in cases where a claimant is not represented by counsel.⁸⁰ This evidence might be applicable in other contexts as well. For example, if industry connections may make arbitrators more predisposed to favor industry defenses, longstanding industry connections might also predispose board members to more naturally sympathize with industry concerns.

Despite its commitment to including public representatives in its governance process, FINRA does not provide much information about the purportedly public representatives on its board of governors. This stands in marked contrast to the availability of information for public companies.⁸¹ The lack of disclosure makes it difficult to assess the

77. FINRA, BY-LAWS OF THE CORPORATION ART. I, § tt.

78. It defines non-public arbitrators as persons that, among other things, are or were "associated with, including registered through, under, or with (as applicable): . . . a broker or a dealer" or "a mutual fund or a hedge fund;" "an investment adviser" or were, within the last five years, "an employee of a bank or other financial institution." FINRA, FINRA MANUAL, R. 12100(p) (2015) (defining non-public arbitrators).

79. See FINRA, FINRA MANUAL, R. 12403(c)(1)(A) (2017) ("Each separately represented party may strike any or all of the arbitrators from the non-public arbitrator list by crossing through the names of the arbitrators."); accord Gross, *supra* note 26, at 184 ("FINRA DR provides customers with the right to select a panel consisting of no arbitrators with ties to the securities industry."); Jason M. Kueser & Bradley Stark, *Investors, Cornered Make Securities Arbitration Elective, Not Mandatory*, 23 PIABA B.J. 81, 86 (2016) ("Because investor advocates successfully argued that the industry arbitrator had potential conflicts of interest, FINRA changed the rule to allow for all public arbitration panels.").

80. Stephen J. Choi et al., *The Influence of Arbitrator Background and Representation on Arbitration Outcomes*, 9 VA. L. & BUS. REV. 43, 48 (2014) ("Our results provide preliminary evidence that FINRA's focus on arbitrator characteristics was valuable in that such characteristics do have the capacity to affect case outcomes.").

81. See *supra* text accompanying notes 271–272.

background of the public representatives named to FINRA's board. For example, FINRA's annual report simply describes several of its purportedly Public Governors as "retired."⁸² The information provided about the remaining Public Governors includes only a title or an affiliation.⁸³

a. Deep Industry Connections

Publicly available information from other sources reveals that the majority of FINRA's board would likely not be deemed "public" under FINRA's own rules for arbitrator classification because of their longstanding industry connections.⁸⁴ Consider the backgrounds of some public representatives on FINRA's board. Joshua S. Levine spent the vast majority of his career in the industry with stints at FanTex Brokerage Services, LLC, Electronic Securities Processing, E*Trade Securities, and Morgan Stanley.⁸⁵ William H. Heyman serves on the board of directors at the Travelers Companies (Travelers), an insurance holding company.⁸⁶ Travelers' annual report provides more information than FINRA, revealing that Mr. Heyman serves as Travelers' chief investment officer and previously served in "various executive positions with Citigroup," as "a managing director of Salomon Brothers," and as "a managing director of Smith Barney."⁸⁷

Similarly, John W. Schmidlin, another Public Governor that FINRA identifies as "Retired," previously served as an executive for JPMorgan Chase.⁸⁸ In 2004, Mr. Schmidlin disclosed that he beneficially owned 270,098 shares of JPMorgan's common stock and served as one of JPMorgan's Managing Directors.⁸⁹ Whether Mr. Schmidlin continues to

82. FINRA, 2015 ANNUAL REPORT, *supra* note 7, at 65.

83. *Id.*

84. It is important to note that FINRA's classifications for public and non-public arbitrators have been criticized as, in some instances, improperly excluding persons without significant industry connections as non-public. For example, Cornell University Law School's Securities Arbitration Clinic and the North American Securities Administrators Association objected to FINRA's decision to classify persons that represent investors in arbitration proceedings as "non-public." Letter from William A. Jacobsen, Cornell Law Professor, & Nathan F. Baum, Cornell Law Student, to Brent J. Fields, SEC Secretary, at 2-3 (Nov. 6, 2014) ("The Clinic Opposes Classifying Investor Representatives as Non-Public."); *accord* Letter from William Beatty, NASAA President, to Brent J. Fields, SEC Secretary (Nov. 6, 2014) ("Applying the term 'non-public' to individuals who represent investors is an arbitrary and incorrect application that the SEC should reject.")

85. For information about Joshua S. Levine's history of working in the industry, see *BROKERCHECK*, www.brokercheck.finra.org. FINRA's rules for arbitrators classify persons that were registered through broker dealer firms as non-public. See FINRA, FINRA MANUAL, R. 12100(p).

86. See The Travelers Companies, Inc., Annual Report 261 (Form 10-K) (Feb. 11, 2016).

87. *Id.* at 262.

88. FINRA, 2015 ANNUAL REPORT, *supra* note 7, at 65.

89. JP Morgan Chase & Co., Statement of Changes in Beneficial Ownership (Form 4) (Feb. 13,

own a substantial position in JPMorgan's stock remains unclear.

b. Divided Loyalties and Dual Roles

In some instances, public members of the FINRA Board of Governors occupy perplexing dual roles. In many instances, FINRA's public representatives have significant industry relationships that may make them particularly sensitive to industry concerns.⁹⁰ For example, FINRA previously identified Robert W. Scully as "Retired" and as a "Public" member of its Board of Governors.⁹¹ During the same period, Mr. Scully also served as board member for KKR & Co. L.P., "a leading global investment firm."⁹² He previously served on the Bank of America Board of Directors in 2013 and has had a "35-year career in the financial services industry."⁹³ On April 5, 2016, UBS Group AG announced Mr. Scully as a candidate for its board.⁹⁴ On May 6, 2016, Mr. Scully stepped down from FINRA's Board of Governors.⁹⁵ He won his election to UBS's board on May 10, 2016.⁹⁶ UBS is a major financial services firm that operates affiliated broker-dealer firms regulated by FINRA. On average, it pays members of its board of directors approximately \$1.2 million per year.⁹⁷

It may be difficult to switch between roles as a public representative on FINRA's Board of Governors and a person offering to serve the stockholder interests of a particular member firm. In one ongoing scandal, UBS sold Puerto Rican bonds to the public even though a group of its own brokers came up with a list of twenty-two reasons why they thought the bonds might be bad for their clients, including "low liquidity,

2004).

90. For a discussion of ideological capture, see note 213.

91. See Benjamin P. Edwards, *Selecting the Public's Representatives in the Financial Regulatory Process*, PRAWFSBLAWG (Aug. 26, 2016), <http://prawfsblawg.blogs.com/prawfsblawg/2016/08/selecting-the-publics-representatives-in-the-financial-regulatory-process.html>.

92. KKR & CO. L.P., Annual Report 5 (Form 10-K) (Feb. 22, 2016).

93. *Id.* at 240.

94. *UBS Publishes Agenda for the Annual General Meeting of UBS Group AG on 10 May 2016*, BUS. WIRE (Apr. 5, 2016) <http://www.businesswire.com/news/home/20160404006491/en/UBS-publishes-agenda-Annual-General-Meeting-UBS>.

95. Telephone Interview with FINRA Officials (Sept. 9, 2016) (notes on file with author).

96. UBS also reveals that Mr. Scully "served as a Member of the Office of the Chairman of Morgan Stanley," as a "Managing Director at Lehman Brothers," and "as Managing Director and for Salomon Brothers in Investment Banking and Capital Markets." *Robert W. Scully*, UBS, https://www.ubs.com/global/en/about_ubs/corporate-governance/board-of-directors/cv-robert-w-scully.html (last visited July 16, 2016).

97. See Patrick Winters & Carolyn Bandel, *Swiss Boards Command Top Pay as Members Refuse 'Peanuts'*, BLOOMBERG (Oct. 29, 2014) <http://www.bloomberg.com/news/articles/2014-10-30/swiss-boards-command-top-pay-as-members-refuse-peanuts>.

excessive leverage, oversupply and instability.”⁹⁸ Resolving some of the regulatory issues in 2015, UBS agreed to pay \$34 million in settlements to regulators for its sales of Puerto Rican bonds.⁹⁹ FINRA even fined UBS \$7.5 million and required it to pay \$11 million in restitution to customers.¹⁰⁰ After one FINRA arbitration panel awarded a customer \$1.5 million in damages, attorneys’ fees, and costs, UBS issued a statement saying that it was “disappointed with the decision to award any damages, with which we respectfully disagree.”¹⁰¹ To the extent that UBS and its shareholders would prefer to pay a reduced amount of damages in arbitrations or regulatory actions, public members with deep industry ties may be particularly sensitive to concerns about “excessive” liability.

Public Governors have also had significant familial connections to FINRA’s member firms. For example, Mr. Scully is married to a managing director at a FINRA-registered firm that provides investment banking services.¹⁰² To the extent that the Board of Governors considers policy relevant to investment banking, close familial connections may also create the appearance of a conflict.

To be sure, these issues may be more appearance than reality; Mr. Scully may be entirely independent and public minded, and long-term industry members may be particularly offended by industry wrongdoing that besmirches the brokerage business. Financial conflicts may matter less for the wealthy than the middle class. A long, successful career as an investment banker may grant a fortune so large that the prospect of a paltry additional million would have no influence on behavior. A move from a public representative position on FINRA’s board to UBS’s board may have occurred because UBS needed additional expertise to address ongoing compliance issues. FINRA may also have benefited significantly from the expertise accumulated over a long industry career.

Although Mr. Scully has departed FINRA’s board, other perplexing concurrent positions persist. FINRA also identifies Randal K. Quarles of the Cynosure Group, an investment advisory firm currently managing over a billion dollars in assets, as a “Public” member of the Board of

98. Suzanne Barlyn, *Recording Shows that UBS Drove Reluctant Brokers to Sell High-Risk Puerto Rico Funds*, BUS. INSIDER (Feb. 6, 2015), <http://www.businessinsider.com/r-exclusive-recording-shows-how-ubs-drove-reluctant-brokers-to-sell-high-risk-puerto-rico-funds-2015-2>.

99. Mike Cherney, *UBS Unit to Pay \$34 Million in Settlements Over Puerto Rico Bond Funds*, WALL ST. J. (Sept. 29, 2015), <http://www.wsj.com/articles/ubs-unit-to-pay-34-million-in-settlements-over-puerto-rico-bond-funds-1443551291.gg>.

100. *Id.*

101. Andrew Welsch, *As Legal Bills Soar, UBS Loses Another Puerto Rico Case*, ON WALL ST. (Feb. 22, 2016), <http://www.onwallstreet.com/news/as-legal-bills-soar-ubs-loses-another-puerto-rico-case>.

102. See Office of Development Communications, *\$20 Million Gift from Peretsman and Scully Names Psychology Building* (Oct. 18, 2012), PRINCETON U., <https://www.princeton.edu/main/news/archive/S35/04/91K34/index.xml?section=topstories>.

Governors.¹⁰³ Mr. Quarles also serves on the Board of Directors of the U.S. Chamber,¹⁰⁴ which describes itself as the “world’s largest business organization representing the interests of more than 3 million businesses.”¹⁰⁵ Mr. Quarles may face a conflict of interest to the extent that his duties to represent business perspectives and the public interest conflict. For an example of a debate that has split business and public advocacy groups, consider the Department of Labor’s new rule imposing a fiduciary duty on financial advisers giving advice in connection with retirement accounts.¹⁰⁶ The American Association of Retired Persons strongly supports the rule because it wants to close “loopholes in the law that allow some financial advisers to give investment advice that earns them a higher fee—even if it’s not the best advice.”¹⁰⁷ The U.S. Chamber opposes the rule and has filed a lawsuit seeking judicial action to strike it down.¹⁰⁸

Perhaps shedding some light on Mr. Quarles’s views, the U.S. Chamber led a particularly aggressive lobbying campaign opposing the rule. According to a report published by *Public Citizen*, the U.S. Chamber created “astroturf” opposition to the rule.¹⁰⁹ In one instance, a person that the U.S. Chamber featured on a website showcasing small business opposition to the rule “did not realize he was listed on the webpage as opposing it” and asked *Public Citizen*, “Who do I call to get this down?”¹¹⁰

103. FINRA, 2015 ANNUAL REPORT, *supra* note 7, at 65. The publicly available Form ADV for Cynosure Management, LLC indicates that it is an investment advisory firm with more than \$1 billion of assets under management. See also Cynosure Mgmt., LLC, *Form ADV: Uniform Application for Investment Adviser Registration and Report by Exempt Reporting Advisers 2* (Mar. 31, 2016), http://www.adviserinfo.sec.gov/IAPD/content/ViewForm/crd_iapd_stream_pdf.aspx?ORG_PK=281399.

104. See *Board of Directors*, U.S. CHAMBER COMMERCE, <https://www.uschamber.com/about-us/board-directors> (last visited July 6, 2016).

105. *About the U.S. Chamber*, U.S. CHAMBER COMMERCE, <https://www.uschamber.com/about-us/about-the-us-chamber> (last visited July 6, 2016).

106. See *Conflict of Interest Final Rule*, U.S. DEP’T OF LABOR, <https://www.dol.gov/ebsa/regs/conflictsofinterest.html> (last visited Aug. 28, 2017).

107. David Certner, *Why AARP Backs a New Retirement Plan Advice Rule*, AARP BLOG (July 22, 2015), <http://blog.aarp.org/2015/07/22/aarp-files-comments-on-new-retirement-plan-advice-rule/>.

108. See Andrew Ackerman & Leslie Scism, *Obama Retirement-Savings Rule Faces Industry-Led Court Battle*, WALL ST. J. (May 31, 2016), <http://www.wsj.com/articles/industry-groups-prepare-lawsuit-over-obama-retirement-rule-1464704230> (“Big business and financial industry trade groups are taking to the courts . . .”).

109. PUBLIC CITIZEN, SACRIFICING THE PAWNS: HOW THE U.S. CHAMBER OF COMMERCE RECRUITS SMALL BUSINESS OWNERS TO LOBBY AGAINST THEIR OWN SELF-INTEREST 8 (2016), <http://www.chamberofcommercewatch.org/wp-content/uploads/2016/06/Sacrificing-the-Pawns-final.pdf>. The term “astroturfing” refers to manufacturing grassroots opposition to regulation on behalf of business and industry interests. See also John Kennedy, *Need a Grass-Roots Campaign? Industries Learn How to Hire One*, SUN SENTINEL (Oct. 28, 1996), http://articles.sun-sentinel.com/1996-10-28/business/9610280244_1_legislators-astroturfing-lobbyist.

110. Daniel Dudis & Bartlett Naylor, *Taking a Hard Look at a Campaign Critical of a Fiduciary*

2. FINRA's Industry Governors

The independence of FINRA's public governors matters because the industry already wields a powerful voice within FINRA, granting it influence over FINRA's priorities.¹¹¹ The industry seems unlikely to pursue investor protection at the expense of profitability. While excess financial services fees paid on account of conflicts of interest are costly to investors, these fees provide profits to FINRA's member firms.¹¹² Accordingly, industry representatives serving within FINRA would seemingly prefer revenue-maximizing arrangements.¹¹³

One successful industry campaign in FINRA's 2015 Board of Governors shows how industry members may advance industry interests. While running to represent midsized firms on FINRA's Board of Governors, the commendably candid Brian Kovack of Kovack Securities stressed that his "main role would be to advocate for" stockbrokers.¹¹⁴ When a follow-up question asked if he would represent investor interests, Kovack replied, "No. I would not."¹¹⁵ After his remarks generated controversy, Kovack took a more diplomatic approach, stating that he looked "forward to working with the other members of the board and with FINRA's member firms to identify regulatory solutions that work both for investors and for the industry."¹¹⁶ Kovack won his election with the endorsement of the Financial Services Institute.¹¹⁷ Kovack has substantial familiarity with the levers of power at FINRA; he previously

Rule, N.Y. TIMES (June 9, 2016), http://www.nytimes.com/2016/06/10/business/dealbook/taking-a-hard-look-at-a-campaign-critical-of-a-fiduciary-rule.html?smid=tw-nytimesbusiness&smtyp=cur&_r=0.

111. For example, FINRA's bylaws provide for substantial industry representation on the board. FINRA BYLAWS, art. VII, § 4(a), ("[T]he Board of Governors shall consist of . . . (iii) a Floor Member Governor, an Independent Dealer/Insurance Affiliate Governor and an Investment Company Affiliate Governor and (iv) three Small Firm Governors, one Mid-Size Firm Governor and three Large Firm Governors.").

112. See Judge, *supra* note 21, at 577 ("Because fees are revenue to the intermediaries to whom they are paid, intermediaries prefer laws, norms, market structures, and other institutional arrangements that entail higher, not lower, transaction fees.").

113. See *id.* ("Moreover, intermediaries often have expertise and other strategic advantages that enable them to affect the processes through which institutions evolve in self-serving ways.").

114. Ann Marsh, *FINRA Candidate Says He'd Represent Firms, Not Investors*, FIN. PLANNING (July 6, 2015), <http://www.financial-planning.com/news/finra-candidate-says-hed-represent-firms-not-investors>.

115. *Id.*

116. Ann Marsh, *Newly Elected FINRA Leader Raises Fiduciary Hackles*, FIN. PLANNING (Aug. 3, 2015), <http://www.financial-planning.com/news/newly-elected-finra-leader-raises-fiduciary-hackles>.

117. See Karen Demasters, *Brian Kovack, 'Dissident' Candidate For FINRA Board, Gets FSI Endorsement*, FIN. PLANNING (July 6, 2015), <http://www.fa-mag.com/news/brian-kovack--dissident-candidate-for-finra-board-of-governors-22334.html> (reporting Financial Services Institute Endorsement); Megan Leonhardt, *Reformers Win Seats on FINRA Board*, WEALTH MGMT. (July 30, 2015), <http://wealthmanagement.com/industry/reformers-win-seats-finra-board> ("Kovack and Romano, both owners of brokerages, campaigned to be elected with a similar messages: Stop antagonizing smaller firms.").

served on its interim board and as a member of the NASD Board of Governors.¹¹⁸

Mr. Kovack's presence raises questions about FINRA's culture and interest in protecting investors.¹¹⁹ One recent study found that, while only about 7% of all stockbrokers have markers on their record indicating possible misconduct, some firms have much higher concentrations of brokers with possible misconduct markers.¹²⁰ At Kovack Securities, 13.13% of the brokers joined the firm after being fired by other firms.¹²¹ Tendencies toward fraud and exploitation may be contagious: when groups of troubled brokers cluster, their colleagues tend to absorb the cultural norms.¹²² One study found that associating with problem brokers increased the likelihood that even individual brokers without potentially problematic disclosures on their records will be associated with misconduct.¹²³ Remarkable on similar findings, two FINRA economists recently theorized that a heightened concentration of brokers with misconduct disclosures might serve "as an indicator of 'compliance culture'" at a particular firm.¹²⁴ The high rate of disclosures may indicate that Kovack Securities' institutional culture does not place as much value on compliance as other firms. A unanimous 2010 arbitration award

118. *FINRA Announces Interim Board of Governors to Serve Until Annual Meeting for Board Elections*, FINRA (Aug. 2, 2007), <https://www.finra.org/newsroom/2007/finra-announces-interim-board-governors-serve-until-annual-meeting-board-elections> ("Brian Kovack, President of Kovack Securities Inc. and a former member of NASD's Board of Governors, appointed by the NASD as an industry representative. Kovack will serve only on the Interim Board.")

119. Financial regulators have begun to pay an increasing amount of attention to the culture of financial services firms because it drives organizational behavior. See Nizan Geslevich Packin & Benjamin P. Edwards, *Regulating Culture: Improving Corporate Governance with Anti-Arbitration Provisions for Whistleblowers*, 58 WM. & MARY L. REV. ONLINE 41 (2016), <http://wmlawreview.org/sites/default/files/Packin%20%26%20Edwards-Final.pdf> (corporate culture has emerged as a regulatory priority in the aftermath of the 2008 financial crisis).

120. See Mark Egan et al., *The Market for Financial Adviser Misconduct* (Feb. 2016) <https://www.chicagobooth.edu/~media/B76C81EFE39B4EDB9A4B4D8B34D0B0F7.pdf> (working paper).

121. Craig McCann et al., *How Widespread and Predictable is Stock Broker Misconduct*, SEC. LITIG. CONSULTING GROUP 32 (June 2016), <http://www.slcg.com/pdf/workingpapers/McCann%20Qin%20and%20Yan%20on%20BrokerCheck.pdf>.

122. See Stephen G. Dimmock et al., *Is Fraud Contagious? Co-Worker Influence on Misconduct by Financial Advisors* 4 (July 10, 2017), <https://papers.ssrn.com/abstract=2577311> (unpublished manuscript) ("Controlling for merger-firm fixed effects and using changes to an advisor's co-workers due to a merger, we show that an advisor is 37% more likely to commit misconduct if his Introduced Branch co-workers have a history of misconduct.")

123. *Id.*

124. One FINRA study found that investor risk rises when a firm has a high concentration of brokers with potential misconduct markers on their records. See Hammad Qureshi & Jonathan S. Sokobin, *Do Investors Have Valuable Information About Brokers?*, 4 (Aug. 20, 2015), <https://papers.ssrn.com/abstract=2652535> ("[W]e find that [harm associated with coworkers] leads to an economically meaningful increase in the overall power to predict investor harm, in the context of our model.")

provides additional support for this inference: the panel ordered Kovack Securities to pay \$200,000 in punitive damages to an investor because of the “apparent lack of any system of supervision” at the firm.¹²⁵ From his position on FINRA’s Board of Governors, Mr. Kovack may be able to influence the organization’s priorities.

While not all industry-affiliated governors share Mr. Kovack’s unique background, the need for independent public representatives remains. Given FINRA’s structure, it should be assumed that the industry will use FINRA’s regulatory apparatus to pursue its own objectives.

III. THE PUBLIC’S INTEREST IN FINANCIAL REGULATION

Evaluating financial regulation requires an understanding of the financial system’s purpose and benefits.¹²⁶ Even with this in mind, it may be difficult to identify when self-regulatory organizations act to promote industry interests at the public’s expense.¹²⁷ In some instances, legitimate investor protection initiatives may only win support when they grant one subset of the industry a competitive advantage over another.

The need for effective supervision of the financial services industry has never been greater.¹²⁸ Ineffective financial services regulation may affect ordinary individuals more directly than ever before by limiting their ability to save for the future. While U.S. households once relied on defined-benefit pensions, the national retirement landscape has shifted toward personally controlled retirement accounts, such as 401(k)s and Individual Retirement Accounts (IRAs).¹²⁹ This structure forces average, financially illiterate citizens to bear the responsibility for allocating their own retirement savings.¹³⁰ Amplifying the challenge, retirement-aged

125. *Tarrant v. Kovack Sec Inc.*, Arb. No. 10-03532, at 2 (FINRA Feb. 13, 2012) (“The situation is more egregious given [that Kovack Securities] was aware the broker had been terminated from another firm due to unreported and unapproved outside activities.”).

126. Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 765 (1985) (explaining that policymakers must keep in mind “the functions that capital markets ideally serve, [to] better understand what benefits we are able to achieve with legal policy”).

127. See Birdthistle & Henderson, *supra* note 2, at 12 (“The problem that observers encounter in evaluating the efficacy and legitimacy of self-regulation is that the steps to create and enforce a cartel are hard to distinguish from steps necessary to help investors through the policing of bad brokers.”).

128. See *id.* at 33 (“[M]ore average investors find themselves in the equities market[,] . . . the stakes for them of effective regulation are higher than they were in the past.”).

129. For a thorough discussion of this change and its implications, see JACOB S. HACKER, *THE GREAT RISK SHIFT: THE NEW ECONOMIC INSECURITY AND THE DECLINE OF THE AMERICAN DREAM* (2008); Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 453 (2004) (“Pension cognoscenti have frequently remarked on the stagnation of defined benefit pensions and the concomitant rise of defined contribution plans.”).

130. See Anne Tucker, *Retirement Revolution: Unmitigated Risks in the Defined Contribution Society*, 51 HOUS. L. REV. 153, 188 (2013) (documenting widespread financial illiteracy); Jacob Hale

persons, many facing cognitive decline, now form the fastest growing cohort of the U.S. population.¹³¹ Many turn to financial advisers for assistance in managing their retirement savings.¹³² Many of these financial advisers are commission-compensated stockbrokers associated with FINRA's member firms.¹³³ These financial advisers frequently give skewed, self-serving advice.¹³⁴ By one conservative estimate, Americans pay an excess \$17 billion in annual fees because of industry conflicts of interest.¹³⁵ A focus on fees may understate the true costs because savers do not earn interest on the funds they have lost to industry fees.

While individuals making savings decisions face personally high stakes, the general public has an even more compelling interest in improving capital allocation.¹³⁶ When functioning well, the financial

Russell, *The Separation of Intelligence and Control: Retirement Savings and the Limits of Soft Paternalism*, 6 WM. & MARY BUS. L. REV. 35, 47 (2015) (explaining that it is “clear is that many individuals make poor decisions in investing their defined-contribution assets This is hardly surprising given the voluminous evidence both on low financial literacy and on behavioral and cognitive biases.”).

131. See Carrie A. Werner, *The Older Population: 2010*, U.S. CENSUS BUREAU (Nov. 2011), <https://www.census.gov/prod/cen2010/briefs/c2010br-09.pdf>; *2012 Alzheimer's Disease Facts and Figures*, ALZHEIMER'S ASS'N 14 (2012), https://www.alz.org/downloads/facts_figures_2012.pdf (explaining that 13% of persons over 65, and 45% of persons over 85, suffer from dementia).

132. Most use the assistance of a financial advisor to craft a retirement plan. Lydia Saad, *U.S. Investors Seek Advice for Some Things More Than Others*, GALLUP (Sept. 12, 2014), http://www.gallup.com/poll/175748/investors-seek-advice-things-others.aspx?utm_source=tagrss&utm_medium=rss&utm_campaign=syndication&utm_reader=feedly.

133. The term “financial advisor” includes a variety of financial services professionals, often stockbrokers. See *Rules and Resources*, FINRA, <https://www.finra.org/investors/rules-and-resources> (last visited Jan. 16, 2016) (explaining that FINRA does not closely regulate the titles used by persons associated with its members and that “Financial Analyst, Financial Adviser (Advisor), Financial Consultant, Financial Planner, Investment Consultant or Wealth Manager are generic terms or job titles, and may be used by investment professionals who may not hold any specific credential”).

134. One study found that persons that used a broker for assistance constructed substantially worse portfolios than the portfolios that were constructed without a broker's assistance. See generally John Chalmers & Jonathan Reuter, *Is Conflicted Investment Advice Better Than No Advice?* (Nat'l Bureau of Econ. Research, Working Paper No. 18158, 2012), <http://www.nber.org/papers/w18158>; Sendhil Mullainathan, Markus Noeth & Antoinette Schoar, *The Market for Financial Advice: An Audit Study* (Nat'l Bureau of Econ. Research, Working Paper No. 17929, 2012), <http://www.nber.org/papers/w17929> (finding that stockbrokers showed a bias toward recommending high fee mutual funds that would pay more compensation to the stockbrokers).

135. See EXEC. OFFICE OF THE PRESIDENT, COUNCIL OF ECONOMIC ADVISERS, *THE EFFECTS OF CONFLICTED INVESTMENT ADVICE ON RETIREMENT SAVINGS 2* (Feb. 2015) (finding “the aggregate annual cost of conflicted advice is about \$17 billion each year” for retirement savers) [hereinafter CEA, *CONFLICTED ADVICE*]. In practical terms, retirees receiving conflicted advice will run out of savings more than five years earlier than if they had received unbiased advice. *Id.* When these retirees deplete their savings, they may consume more public resources or depend on support from their families, reducing the next generation's ability to save and invest for the future.

136. Charles K. Whitehead, *Reframing Financial Regulation*, 90 B.U. L. REV. 1, 35 (2010) (“The basic goals of the markets have remained the same – namely, the efficient allocation, transfer, and deployment of capital resources and risk-bearing.”); See also Lynn A. Stout, *The Corporation As Time Machine: Intergenerational Equity, Intergenerational Efficiency, and the Corporate Form*, 38 SEATTLE U. L. REV. 685, 686 (2015) (explaining that capital markets “can transform wealth that will be generated

system efficiently transfers investor capital to productive opportunities. This produces benefits for all parties. Investors earn risk-adjusted returns, businesses put money to work, and financial intermediaries collect fees for their services. Importantly, the efficiency of capital allocation may be measured as the cost of moving capital from savers to profitable opportunities.¹³⁷ If the market for financial intermediation were truly competitive, competition between profit-seeking financial intermediaries would drive down the fees charged for financial intermediation, freeing more investor capital for productive use.

A. Reduce Intermediation Costs

Excessive fees for self-regulating intermediaries may mean that otherwise value-increasing transactions will never occur.¹³⁸ For example, imagine that Afra and Beydoun place different values on an asset. If the asset is worth 100 to Afra and 105 to Beydoun, it would make sense for Afra to sell the asset to Beydoun. When Afra and Beydoun do not know each other or transact directly, an intermediary may profit by connecting them. If Cathren, the intermediary, extracts a fee of 10, the transaction will never occur. Afra will only be willing to sell the asset for something more than 100. Beydoun will not pay 110 for asset valued at 105.

At present, the transaction fees for ordinary stock market transactions have declined substantially because of repeated outside intervention. For example, the self-regulatory exchanges maintained artificially high, fixed-rate commissions for all stock transactions until the SEC abolished the practice in 1975.¹³⁹ Even after the SEC abolished fixed commissions, industry members colluded to raise trading costs indirectly by

in the future into wealth that can be enjoyed today in the form of a higher share price”); JOHN KAY, *OTHER PEOPLE’S MONEY: THE REAL BUSINESS OF FINANCE* 135 (2015) (“A central function of financial markets is to direct money from savers to businesses, home-owners and governments. They in turn use these savings to build, own and operate houses, shops, offices, warehouses and factories”); Kathryn Judge, *Fee Effects*, 98 IOWA L. REV. 1517, 1539 (2013) (“[T]he intermediary plays a critical role linking (and separating) the investor, on one hand, and the project in which his money is ultimately invested on the other.”).

137. See Wallace C. Turbeville, *A New Perspective on the Costs and Benefits of Financial Regulation: Inefficiency of Capital Intermediation in A Deregulated System*, 72 MD. L. REV. 1173, 1176 (2013) (“[T]he principal social value of financial markets is not to assure the lowest transaction costs for market participants. Rather, it is to facilitate the efficient deployment of funds held by investors to productive uses.”).

138. See Judge, *supra* note 21, at 625.

139. Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 408 (2002) (“The abolition of fixed-rate brokerage commissions in 1975 transformed the economics of the securities industry.”).

manipulating the bid–ask spread for stocks.¹⁴⁰ In the so-called “odd-eighth” affair, academics published research indicating that market-makers were colluding to inflate trading costs.¹⁴¹

Notably, these reductions in trading costs came through outside pressure from government and as a result of academic research, not from a self-regulatory body acting to curb transaction costs. In fact, FINRA’s precursor knowingly tolerated the problem. After the odd-eighth scandal, the SEC released a report on the fiasco, known as the “21(a) Report.”¹⁴² The report revealed that industry members had “engaged in a variety of abusive practices to suppress competition and mislead customers” and that the self-regulatory organization had done nothing about it despite knowing the “facts and circumstances” for a substantial time.¹⁴³

B. Mitigate Capital Misallocation and Conflicts of Interest

The public’s interest in efficient capital allocation may also be undercut when conflicts of interest cause financial intermediaries to misallocate capital.¹⁴⁴ Conflicts of interest sometimes cause intermediaries to steer clients away from the most productive opportunities and toward transactions that increase intermediary profits.¹⁴⁵ The misdirection of investor capital to secure transaction fees means that the financial system will allocate capital in suboptimal ways.

This problem may be particularly acute in the retail sector, where a substantial sophistication gap often exists between commission-compensated financial advisers and their clients.¹⁴⁶ These advisers face an ever-present incentive to tilt their advice in ways that increase their own compensation.¹⁴⁷ When consumers fail to understand complex financial products, financial advisers may more easily steer them toward relatively poorer choices.¹⁴⁸ For most retail customers, these higher-fee

140. See William G. Christie & Paul H. Schultz, *Policy Watch: Did Nasdaq Market Makers Implicitly Collude?*, 9 J. ECON. PERSP. 199, 200–01 (1995); William G. Christie & Paul H. Schultz, *Why Do NASDAQ Market Makers Avoid Odd-Eighth Quotes?*, 49 J. FIN. 1813 (1994).

141. *Id.*

142. NASD & Nasdaq, Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 (1996) [hereinafter SEC, 21A Report].

143. *Id.* at 1.

144. See Edwards, *supra* note 19, at 188–194 (discussing capital misallocation).

145. Judge, *supra* note 136, at 1530–31 (explaining that social costs can take the form of foregone gains).

146. See Edwards, *supra* note 19, at 190 (discussing sophistication gap).

147. See Benjamin P. Edwards, *Fiduciary Duty and Investment Advice: Will A Uniform Fiduciary Duty Make A Material Difference?*, J. BUS. & SEC. L., Spring 2014, at 105, 121 (“These distorting incentives have long been recognized as creating material conflicts between the Broker’s interests and the client’s interests.”).

148. See Barbara Black, *Curbing Broker-Dealers’ Abusive Sales Practices: Does Professor*

transactions will rarely be the most prudent decision.¹⁴⁹

When financial-adviser conflicts of interest induce poor capital allocation decisions, it harms individuals and the economy as a whole.¹⁵⁰ For individuals, purchasing a higher-fee product may result in significant changes to retirement outcomes. For example, consider the different outcomes for investors purchasing otherwise-identical index funds with different fee levels. Class L shares of the Great-West S&P 500 Index Fund cost 0.85% in annual fees to replicate the performance of the S&P 500 index.¹⁵¹ In contrast, Vanguard also provides a S&P 500 Index Fund that charges 0.05% in annual fees.¹⁵² Over time, these fee differences become significant.¹⁵³ If the S&P rises 6.5% for twenty years, \$100,000 in the Great West fund will increase to \$297,281.31, with \$30,782.88 going to fees over the years. In contrast, the lower-fee fund will rise to \$348,858.72 and cost less than \$2,000 in fees.¹⁵⁴

Collectively, retail investors control a vast pool of capital. Given the social problems that flow from transactional fees and capital misallocation, the public has a strong interest in reforms that tend to improve how retail investors allocate capital.¹⁵⁵ Incentives toward misallocation and inefficiency can drive many problems, ranging from misdirected financial innovation¹⁵⁶ to increases in the cost of capital, as

Jensen's Integrity Framework Offer A Better Approach?, 48 WAKE FOREST L. REV. 771, 772 (2013) (“Because of investors’ general low level of financial literacy and the complexity of investment products, it is difficult for most retail customers to assess the investment choices recommended by the registered representatives who service their accounts.”); Lauren E. Willis, *Performance-Based Consumer Law*, 82 U. CHI. L. REV. 1309, 1311 (2015) (“In a growing number of consumer transactions today, firms exploit consumer confusion and promote poor buying choices. The resulting transactions are often lousy, whether one uses autonomy, welfare, or fairness as the metric.”).

149. One former stockbroker coined “Brown’s law of brokerage product compensation,” instructing that “[t]he higher the commission or selling concession a broker is paid to sell a product, the worse that product will be for his or her clients.” JOSHUA M. BROWN, *BACKSTAGE WALL STREET: AN INSIDER’S GUIDE TO KNOWING WHO TO TRUST, WHO TO RUN FROM, AND HOW TO MAXIMIZE YOUR INVESTMENTS* 217–18 (2012).

150. Jacob Hale Russell has explained that retail investors purchase higher-fee funds because their financial advisers are paid kickbacks for selling them higher-fee funds. Russell, *supra* note 130, at 57 (explaining that people pick high-fee funds because of an “advice-giver who is financially incentivized through (entirely legal) direct or indirect kickbacks”).

151. For a copy of the prospectus, see *Great-West S&P 500 Index L MXVJX*, MORNINGSTAR, <http://quicktake.morningstar.com/syndication/filing.aspx?cn=GLG117&symbol=MXVJX> (last visited Oct. 12, 2016).

152. For a copy of the prospectus, see *Vanguard S&P 500 Index Fund ETF Class (NYSE Arca : VOO)*, VANGUARD, <https://personal.vanguard.com/us/stocks/prospectus?Ticker=VOO> (last visited Oct. 12, 2016).

153. FINRA’s “Fund Analyzer” performs these calculations. *Fund Analyzer*, FINRA, <http://apps.finra.org/fundanalyzer/1/fa.aspx> (last visited Oct. 12, 2016).

154. *Id.*

155. See Edwards, *supra* note 19.

156. See Brian J. Henderson & Neil D. Pearson, *The Dark Side of Financial Innovation: A Case Study of the Pricing of a Retail Financial Product*, 100 J. FIN. ECON. 227, 228 (2011) (concluding that

issuers seek to induce sales through payments to financial intermediaries.¹⁵⁷

IV. A CRITICAL VIEW OF INDUSTRY SELF-REGULATION

A variety of arguments have been made in favor of FINRA's self-regulatory model. This Article carefully considers some of the most prominent justifications for self-regulation.

A. Traditional Justifications for Self-Regulation

1. The Limited Economic Incentive to Self-Police

The main premise behind self-regulation is that “the industry has a strong incentive to police itself in order to maintain its quality.”¹⁵⁸ This incentive to self-police exists when “many of the costs of misbehavior are born by all members of the profession while the benefits inure only to the misbehaving few.”¹⁵⁹ Notice here that profit-seeking industry self-regulators will likely define “misbehavior” as actions that impose costs or reduce the profits of the industry as a whole—not necessarily as activities that reduce investor welfare or generate costs elsewhere.¹⁶⁰ For example, self-regulating manufacturers may not limit environmental pollution because distant customers do not bear the environmental costs generated by their operations.¹⁶¹ Their customers may even prefer pollution-spewing factories because they pay less for goods and bear no liability for the environmental cleanup.

The NYSE's history as a self-regulating exchange bears this out. Traditionally, the NYSE aggressively policed its own ranks to prevent its members from undercutting the standard fixed commission rates.¹⁶² It did

retail investors pay, on average, an 8% premium over fair market value for certain complex financial products).

157. Cf. Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945 (1993) (“The lower the cost of capital to a nation's entrepreneurs, the more that will be purchased.”).

158. COFFEE ET AL., *supra* note 23, at 690.

159. Birdthistle & Henderson, *supra* note 2, at 8.

160. Cf. Kristin N. Johnson, *Governing Financial Markets: Regulating Conflicts*, 88 WASH. L. REV. 185, 203 (2013) (“The monitoring and enforcement policies that [self-regulatory] governing authorities adopt do not, however, always align with federal policies or regulatory goals.”).

161. See, e.g., Birdthistle & Henderson, *supra* note 2, at 9 (“Pollution may be profit maximizing for firms in the absence of regulation because costs (such as damage to air, vegetation, or water) are imposed on others.”).

162. *Institution of Experience: Coherence of the Self-Regulatory Regime*, *supra* note 30 (“From the first, however, this member-controlled regime inevitably favored the floor over the investors that it served, particularly in enforcement.”).

not, however, aggressively police its members' extraordinarily profitable market-manipulating stock pools.¹⁶³ The incentive to self-police, therefore, failed to check exploitation of the public for at least two reasons: (i) the NYSE members that did not participate in the stock pools still profited because of the heightened trading volume;¹⁶⁴ and (ii) the stock pool operators controlled the NYSE governing committee.¹⁶⁵

The incentive to self-police may also have been limited because Wall Street's broker-dealer firms internalized only a limited portion of the costs that their misbehavior imposed on the public. In theory, contractual relationships between broker-dealer firms and their customers should allow customers to impose costs incurred from misbehavior and disloyalty on the industry.¹⁶⁶ When contractual relationships do not transfer the costs of misbehavior back to the industry, this incentive to self-police diminishes.

In practice, arbitration contracts may inhibit this feedback mechanism.¹⁶⁷ Nearly all customers of FINRA's member firms are required to sign arbitration agreements when they open their accounts.¹⁶⁸ This means that any dispute arising later must be resolved within FINRA's proprietary arbitration forum.¹⁶⁹ Significant portions of the investing public with relatively modest claims may struggle to find representation or to pay "upfront costs such as filing fees, forum fees, and expert witness fees" that are often necessary to proceed.¹⁷⁰ Even if an investor manages to secure an award in the industry forum, there is a

163. See, e.g., PERINO, *supra* note 32, at 269 (explaining that although "[e]veryone in the country seemed to know that there was a pool of R.C.A. stock organized . . . by Michael Meehan, a specialist and member of the [NYSE]" that "netted participants \$5 million in one week," the NYSE "didn't see the need to investigate it until the summer of 1932").

164. Cf. DOUGLAS, *supra* note 43, at 292 (relating the tale of how a Goldman Sachs representative complained to the SEC about the reduced trading volume after the New Deal).

165. See *Institution of Experience: Public Relations and Partial Reforms*, *supra* note 33 ("[T]he real power at the NYSE—the governing committee—was dominated by the floor traders and specialists who considered pools to be prerequisites of the trade."); accord Birdthistle & Henderson, *supra* note 2, at 8 (noting that the self-regulatory process would not work if the misbehaving few gain control).

166. In theory, self-regulation may function better in the broker-dealer industry than in the manufacturing business because "the harm caused by bad brokers . . . is primarily borne by the individuals who are in a contractual relationship with the broker." Birdthistle & Henderson, *supra* note 2, at 10.

167. See Jill E. Fisch, *Top Cop or Regulatory Flop? The SEC at 75*, 95 VA. L. REV. 785, 802 (2009) ("For years, critics have charged that the system is biased in favor of the industry, yet FINRA has failed to provide sufficient transparency to test this claim empirically.").

168. Jill Gross, *The Improbable Birth and Conceivable Death of the Securities Arbitration Clinic*, 15 CARDOZO J. CONFLICT RESOL. 597, 598–99 (2014) ("Virtually all broker-dealers—and many investment advisors—now include a pre-dispute arbitration clause in their retail customers' account agreements.").

169. *Id.* at 599 (explaining that these clauses mean that customers must "arbitrate th[eir] claims in the FINRA arbitration forum" instead of resolving them in court proceedings).

170. *Id.* at 600.

strong chance that the award may never be paid.¹⁷¹ One recent study found that approximately one out of every three FINRA arbitration awards goes unpaid.¹⁷² This accountability breakdown means that the industry has no need to self-police as vigorously as it would if the costs were borne by the industry.¹⁷³

2. Regulatory Expertise and Flexibility

FINRA's self-regulatory structure may generate more thoughtful and precise regulation by bringing industry experts into the regulatory process.¹⁷⁴ Industry participants will always know more about their operations and business model than more distant government regulators.¹⁷⁵

Additionally, regulatory expertise is particularly valuable when overseeing the modern, highly complex financial market place.¹⁷⁶ In the aftermath of the 2008 financial crisis, a key finding emerged—many government regulators did not understand the industries they were supposedly monitoring.¹⁷⁷ To partially overcome this problem, some evidence indicates that FINRA at least listens closely to industry member concerns. For example, current FINRA Governor Brian Kovack previously served as a FINRA District Committee Member.¹⁷⁸ He reported that FINRA provided him with a secure portal to submit

171. See Per Jebsen, *How to Fix Unpaid Arbitration Awards*, 26 PACE L. REV. 183, 183 (2005) (“[I]n a significant fraction of cases, an investor with a duly obtained award is simply never paid, usually because the errant brokerage firm or broker has gone out of business.”).

172. HUGH D. BERKSON, UNPAID ARBITRATION AWARDS: A PROBLEM THE INDUSTRY CREATED – A PROBLEM THE INDUSTRY MUST FIX 2 (2016), [https://piaba.org/system/files/pdfs/Unpaid%20Arbitration%20Awards%20-%20A%20Problem%20The%20Industry%20Created%20-%20A%20Problem%20The%20Industry%20Must%20Fix%20\(February%2025,%202016\).pdf](https://piaba.org/system/files/pdfs/Unpaid%20Arbitration%20Awards%20-%20A%20Problem%20The%20Industry%20Created%20-%20A%20Problem%20The%20Industry%20Must%20Fix%20(February%2025,%202016).pdf).

173. See Benjamin P. Edwards, *Why Broker-Dealers and Financial Advisers Should Be Required to Carry Insurance*, INVESTMENTNEWS (Jun. 15, 2016), <http://www.investmentnews.com/article/20160615/BLOG09/160619954/why-broker-dealers-and-financial-advisers-should-be-required-to> (arguing that an insurance-type scheme would cause the industry to internalize the costs it imposes on investors).

174. Birdthistle & Henderson, *supra* note 2, at 55 (“[T]he greatest single benefit that self-regulation possesses . . . is its access to direct industry expertise.”).

175. See Dorit Rubinstein Reiss, *The Benefits of Capture*, 47 WAKE FOREST L. REV. 569, 597 (2012) (“It is the industry people who work on the ground and know what is really happening.”).

176. See Johnson, *supra* note 160, at 203 (“Deferring to SROs allows government regulators to benefit from SRO boards of directors and governing committees’ sophisticated understanding of conventional and exotic financial instruments.”).

177. Cf. BOSTON CONSULTING GRP., U.S. SECURITIES AND EXCHANGE COMMISSION: ORGANIZATIONAL STUDY AND REFORM 59–60 (2011) (finding that “senior SEC managers described the staff’s understanding of market technologies as ‘basic’ and expressed a clear interest to invest in additional resources”).

178. See FIN. SERV. INST., FSIVOICE: FINRA DISTRICT COMMITTEE MEMBERS 14 (2015).

concerns, access to senior leaders, and thoughtful consideration of any issues he raised.¹⁷⁹

Still, the potential for easier access to industry expertise does not guarantee that FINRA will deploy that expertise effectively in overseeing its members.¹⁸⁰ In fact, one danger is that expertise will be used to craft easily evaded, loophole-ridden rules. For example, Jill Fisch and Hillary Sale criticized the NASD's oversight of analyst conflicts as insufficient.¹⁸¹ They explained that even after reform, "the rules remain fraught with loopholes."¹⁸²

Importantly, analyst regulation impacts the public more than industry insiders. Industry members have long known that many analyst reports were little more than marketing materials. In contrast, the public investors that rely on analyst research often fail to appreciate the conflicts of interest, and thus fall victim to industry conflicts.

3. Improved Compliance and Rulemaking

One traditional rationale for self-regulation is that close industry participation generates compliance benefits because the industry may be more likely to comply with internally generated rules than externally imposed ones.¹⁸³ At the least, industry participation in the rulemaking process likely increases the perceived legitimacy of any rule imposed by a regulator. Industry participation theoretically also expedites the rulemaking process by generally improving the flow of information from the regulated to the regulator.

Yet self-regulation does not ensure complete compliance. Some evidence indicates that broker-dealer firms may not feel morally bound to comply with industry-made rules. For example, Harry Markopolos, the financial analyst that repeatedly tipped off the SEC about Madoff's fraud years before the record-shattering Ponzi scheme collapsed, reports that when he began working in the industry he learned "that dishonest actions also had consequences—often you ended up making a lot more money."¹⁸⁴ He explained that after he learned the industry's regulations,

179. *Id.*

180. Indeed, FINRA's lax oversight of the securities industry has attracted substantial criticism. See Fisch, *supra* note 167, at 800 ("Although it is difficult to ascertain the effectiveness of FINRA's oversight from its disclosures, there have been obvious shortcomings.")

181. See Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1043–45 (2003) (reporting findings that the NYSE and the NASD failed to enforce rules governing analyst conflicts of interest effectively).

182. *Id.* at 1074.

183. See COFFEE ET AL., *supra* note 23, at 688 ("[S]elf-regulation invites the participation of the regulated, thereby increasing the prospect of law compliance.")

184. HARRY MARKOPOLOS, NO ONE WOULD LISTEN: A TRUE FINANCIAL THRILLER 13 (2010).

he “saw them broken every day, every hour; and everybody knew about it and nobody seemed to care.”¹⁸⁵

Many industry members share Markopolos’ assessment about the rate of compliance. One recent survey found that 23% of financial services employees believe it likely “that fellow employees have engaged in illegal or unethical activity in order to gain an advantage over competitors or others at the company.”¹⁸⁶ The same study found that about 25% of the industry believed that industry members “must at least sometimes engage in illegal or unethical activity to be successful.”¹⁸⁷

a. Cost Avoidance

Self-regulation has also been promoted on the ground that it provides significant cost savings.¹⁸⁸ In theory, its greater expertise should allow it to function more cost effectively because it would enjoy lower information-acquisition and analysis cost as well as the support of the industry.¹⁸⁹ FINRA also enjoys the ability to tax its members, supporting its operations through industry fees instead of taxpayer dollars.¹⁹⁰ In contrast, the SEC’s operations may be inhibited by limited appropriations from Congress.

Self-regulatory organizations may also be able to act more efficiently because they do not face the same constraints as state actors. Still, they may increase coordination costs for working with state actors because they may resist coordinated action to avoid being characterized as an arm of the state. For example, Steven Irwin, the Pennsylvania Securities Commissioner, testified before Congress in 2011 that FINRA had resisted cooperation with state regulators out of an “extreme sensitivity to being labeled a state actor.”¹⁹¹

Of course, the old adage, “you get what you pay for” has some applicability. Because industry firms pay for their regulation, they may receive significant benefits. To the extent it generates more responsive

185. *Id.* at 14–15 (“These were clear felonies and the NASD didn’t even respond,” despite documented complaints.).

186. ANN TENBRUNSEL & JORDAN THOMAS, U. OF NOTRE DAME & LABATON SUCHAROW LLP, *THE STREET, THE BULL AND THE CRISIS: A SURVEY OF THE US & UK FINANCIAL SERVICES INDUSTRY 4* (May 2015), https://www.secwhistlebloweradvocate.com/pdf/Labatton-2015-Survey-report_12.pdf.

187. *Id.* at 3.

188. *See* Birdthistle & Henderson, *supra* note 2, at 57.

189. *See id.*

190. *See* COFFEE ET AL., *supra* note 23, at 685.

191. *Ensuring Appropriate Regulatory Oversight of Broker-Dealers and Legislative Proposals To Improve Investment Advisor Oversight: Hearing Before the H. Subcomm. on Capital Mkts. & Gov’t Sponsored Enterprises*, 112th Cong. (2011) (statement of Steven D. Irwin, Commissioner, Pennsylvania Securities Commission, and Chairman, Federal Legislative Committee of the North American Securities Administrators Association, Inc.).

and efficient regulators, self-regulation serves a useful purpose. Evidence also indicates that self-regulating firms may “get” a regulatory environment that maintains higher fees for financial intermediaries.¹⁹² Notably, Thomas Philippon’s review found that the costs of financial intermediation have not decreased in a century despite improvements in information technology.¹⁹³ Thus, the public does not experience net cost savings if self-regulation leads to costlier financial intermediation.

Putting aside the excessive cost of financial intermediation, some skeptics doubt that the use of a self-regulatory organization actually decreases the cost of oversight. Rather, inserting the self-regulatory structure may simply add another layer of oversight and increase overall costs.¹⁹⁴ To function effectively, these skeptics suggest that any self-regulatory organization will undoubtedly need to create a bureaucracy similar in size and scope to the organization that would be created by a government regulator.¹⁹⁵

B. Self-Regulation’s Risks

While a well-functioning self-regulatory structure offers numerous benefits, it also comes with significant risks, which, if unchecked, may swamp any benefits obtained through the self-regulatory structure. At base, many issues stem from core conflicts of interests between the regulatory duties of self-regulatory organizations and their members’ interests.¹⁹⁶

Given these conflicts of interest, most observers accept that self-regulatory organizations often fail to effectively protect the public’s interests.¹⁹⁷ Still, insights into how to improve organizational

192. See Judge, *supra* note 21, at 610 (explaining that financial market intermediaries often “impede the evolution of market structures toward more-efficient forms”).

193. See Philippon, *supra* note 12, at 5.

194. See U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-11-623, PRIVATE FUND ADVISERS: ALTHOUGH A SELF-REGULATORY ORGANIZATION COULD SUPPLEMENT SEC OVERSIGHT, IT WOULD PRESENT CHALLENGES AND TRADE-OFFS 20 (2011) [hereinafter GAO, CHALLENGES & TRADE-OFFS] (explaining that the SRO structure may “increase the overall cost of regulation by adding another layer of oversight”).

195. Miller, *supra* note 14, at 862 (explaining that not “much attention has been given, however, to how this industry expertise is conscripted”).

196. See Concept Release Concerning Self-Regulation, Exchange Act Release No. 50700, 2004 WL 2648179, at *6 (Nov. 18, 2004) [hereinafter SEC Concept Release] (“Among the most controversial features of the existing SRO system is the inherent conflict that exists within every SRO between its regulatory functions and its members, market operations, listed issuers, and shareholders.”).

197. See Karmel, *supra* note 2, at 197 (“[C]riticism of SROs as being insufficiently responsive to the public interest has been leveled over the years by Congress . . .”); David G. Tittsworth, *H.R. 4624: The Pitfalls of A Self-Regulatory Organization for Investment Advisers and Why User Fees Would Better Accomplish the Goal of Investment Adviser Accountability*, 87 ST. JOHN’S L. REV. 477, 483 (2013) (“[T]he effectiveness of SROs has not been demonstrated.”); Orenbach, *supra* note 56, at 152 (“FINRA has a

performance emerge from careful review of the different ways in which this failure occurs.

1. Cartelization

One of self-regulation's major dangers is that it may give industry members "the ability to reduce competition and to raise their own profits."¹⁹⁸ This problem, known as "cartelization," manifests itself as the tendency for "industry to protect itself from external competition or regulation that might be social welfare enhancing."¹⁹⁹

Particular groups within self-regulatory organizations may also use their regulatory power in anticompetitive ways by crafting regulations that disproportionately burden their competitors.²⁰⁰ In particular, regulations imposing fixed costs that do not scale with firm size may have more significant effects on small firms.

It may not always be possible to discern whether a self-regulatory organization seeks to protect the public or to limit the ability of new entrants to drive down costs. Consider, for example, the emergence of so-called robo-advisers.²⁰¹ Financial technology companies have begun to offer automated investment advice platforms that use algorithms to select assets for investors. In many instances, these robo-advisers provide services at a fraction of the cost.²⁰² Responding to their emergence, FINRA recently released a report discussing how existing FINRA obligations apply to robo-advice platforms.²⁰³ While the existing obligations provide investor protections, they also create compliance costs and may make it more difficult for new entrants. In this context, it is difficult to distinguish legitimate investor protection initiatives from interventions designed to drive up costs for a potentially disruptive competitor.

track record of missing many of the major scandals in the securities industry."); MARKOPOLOS, *supra* note 184, at 229 (testifying before Congress that self-regulatory organizations "were there to assist industry in avoiding stricter regulation from the SEC").

198. Birdthistle & Henderson, *supra* note 2, at 10.

199. COFFEE ET AL., *supra* note 23, at 692; *accord* Miller, *supra* note 14, at 867–68.

200. *See* Birdthistle & Henderson, *supra* note 2, at 48 ("For large broker-dealers, not only are compliance costs of little harm (if they amount to an industry-wide tax), but they may be valuable.").

201. *See* Anne Tergesen, *Robo Advisers Seen Exploding in Popularity*, WALL ST. J. (Dec. 11, 2015), <http://www.wsj.com/articles/robo-advisers-seen-exploding-in-popularity-1449860367?cb=logged0.12484590127132833> (explaining that robo-advice "firms typically use algorithms to recommend and manage portfolios of low-cost funds for investors, including implementing tax-saving trades").

202. *Id.*

203. FINRA, REPORT ON DIGITAL INVESTMENT ADVICE 1 (Mar. 2016), <http://www.finra.org/sites/default/files/digital-investment-advice-report.pdf>.

2. Regulatory Capture

The literature on regulatory capture explains mechanisms through which industry may influence regulatory activity.²⁰⁴ While the term has been used in many different ways, it generally “denotes the misalignment of incentives of government actors who pursue narrow private interests that may conflict with the public interest they purport to serve.”²⁰⁵ In addition to this definition, scholars suggest that capture may best be understood as a question of degree.²⁰⁶ At one extreme, a “captured” regulator would act entirely in the interest of the industry. Yet capture’s effects also appear in subtler manifestations. Some have even expressed concern that close connections may generate sympathy or lax enforcement.²⁰⁷ Perspective remains important when seeking reform. Regulators will likely not improve outcomes or protect the public by fostering hostile relationships with the industry.²⁰⁸

The existence of a “revolving door” between positions in regulation and industry does not always mean that officials will shirk enforcement when in regulatory positions.²⁰⁹ In fact, regulators eyeing a move to the industry side face incentives even to over-enforce rules or over-regulate. For example, a number of headline-grabbing enforcement actions can signal a particular official’s talent and competitive zeal.²¹⁰ Industry employers looking to acquire talent may pay a premium for a star. Regulators may also have incentives to elevate an industry’s regulatory burden to increase the industry’s need to hire former regulators for compliance positions.²¹¹

At present, most observers conclude that the regulation of financial services exhibits a high degree of capture.²¹² FINRA may exhibit higher

204. See Saule T. Omarova, *Bankers, Bureaucrats, and Guardians: Toward Tripartism in Financial Services Regulation*, 37 J. CORP. L. 621, 629 (2012) (describing regulatory capture).

205. *Id.* at 630.

206. See David Freeman Engstrom, *Corralling Capture*, 36 HARV. J. L. & PUB. POL’Y 31, 33 (2013) (“Legal scholars and political scientists now also talk about ‘strong’ versus ‘weak’ forms of capture.”).

207. Veronica Root, *Modern-Day Monitorships*, 33 YALE J. ON REG. 109, 144 (2016) (“Scholars have expressed concern that such a close relationship could lead to sympathy from the regulator or monitor toward the organization that engaged in misconduct as well as ‘lax enforcement.’”).

208. See Reiss, *supra* note 175, at 610 (“A blanket condemnation of close relationships between industry and regulators by naming them capture is problematic and can lead to sacrificing potential advantages.”).

209. See Wentong Zheng, *The Revolving Door*, 90 NOTRE DAME L. REV. 1265, 1266 (2015).

210. *Id.* at 1276–80 (“[W]hen industry employers look for regulatory expertise in their agency hires, regulators will have incentives to be more aggressive towards the industry as a way of demonstrating that they possess the qualities sought by the employers.”).

211. *Id.* at 1281 (“[R]egulators who contemplate moving to the private sector may focus their efforts not on whether the rules they are making are friendly or unfriendly to their prospective industry employers, but on whether the rules are broad enough and complex enough to require expertise in interpretation.”).

212. See Omarova, *supra* note 204, at 630 (“In the financial services sector, regulatory capture is

degrees of capture than traditional regulators because industry members both make and abide by regulations at the same time. At the very least, however, concurrent self-regulators and industry members do not need to demonstrate administrative vigor or create additional regulatory burdens to secure jobs that they already have.

To be sure, self-regulatory organizations also employ independent staff who may face the same incentives as traditional agency staff. But because these counterbalancing incentives operate with less strength, self-regulatory organizations still may be more prone to acting in the industry's interest than are traditional administrative agencies.

Even with independent, effective, and competent frontline personnel, financial regulators may perform poorly if the "message from the top skews their effectiveness."²¹³ For example, an organization's board may reduce enforcement budgets or issue directives to expedite oversight examinations. While it is not clear whether FINRA personnel share his beliefs, FINRA Board of Governors' member Brian Kovack campaigned on a promise to seek "immediate reforms" in FINRA's arbitration process, oversight examinations, and required disclosures.²¹⁴ To whatever extent that personally independent, lower-level FINRA employees believe in the need for more vigorous enforcement, they may face pressure from the organization's leadership to reduce enforcement vigor, against the public's interest.

Maintaining an incentive to act in the public's interest is particularly important because potent structural forces also drive regulatory capture.²¹⁵ Unlike the widely diffused public, well-organized industry groups have significant incentives to focus on the intricate details of financial regulation. Because most rules will only have a slight impact on individual members of the public, the public has little incentive to pay attention to the regulatory process. In contrast, industry profits may rise and fall significantly with financial regulation, and industry members have strong incentives to seek rents.

particularly pervasive and difficult to avoid."); Tuch, *supra* note 20, at 158 ("Regulatory capture theory may nevertheless help in understanding a self-regulator's enforcement weaknesses.").

213. Solomon, *supra* note 71 (explaining that ideological capture occurs when regulators "share the same beliefs and ideas as their industry").

214. Melanie Waddell, 'Dissident' Candidate Vies for FINRA Board Seat, THINKADVISOR (July 7, 2015), <http://www.thinkadvisor.com/2015/07/07/dissident-candidate-vies-for-finra-board-seat> (quoting Brian Kovack) (In particular, he claimed that the industry-controlled arbitration forum needed better methods to deal with "frivolous claims," that the examination process could be more efficient, and that "exceptions" should be created to reduce the information brokers must disclose in their reports about "unsatisfied judgments and liens or agreements with creditors.").

215. See Engstrom, *Corralling Capture*, *supra* note 206, at 32 ("[C]apture is a structural problem that allows some interests to systematically win out over others.").

3. Inactivity and Lax Enforcement

Self-regulatory organizations may fail to protect the public's interest by failing to address known problems. While traditional regulatory agencies may also be prone to inaction, self-regulatory bodies may be particularly lethargic protectors in situations where actions in the public's interest would undercut private profits. On these issues, government action or public outcry may, on occasion, prod them into halting action.

Consider the long history of inaction on unpaid arbitration awards. In 2000, the Government Accountability Office reported that approximately "61 percent . . . of investors who won arbitration awards in 1998 either were not paid or received only partial payment."²¹⁶ A follow up report indicated that in 2001, approximately "33 percent of . . . awards on claims filed by investors were not fully paid."²¹⁷ Nonpayment has continued. An analysis of 2013 awards showed that more than a third of investor awards went unpaid in 2013.²¹⁸

The issue over unpaid awards matters because it cuts to a core premise behind self-regulation: self-regulation works well if the industry bears the costs of its misbehavior.²¹⁹ Despite this, FINRA does not require its firms to acquire insurance to bear the costs of their operations or to maintain significant capital reserves.²²⁰ While FINRA does expel member firms that fail to pay arbitration awards, the individuals employed by those firms often simply relocate to another firm and continue with business as usual.²²¹ The practice is so common that the term "cockroaching" was coined to describe "brokers moving from one problem firm to another."²²² While reform advocates have suggested creating a national compensation pool to address the issue, FINRA has not been particularly active on the issue.²²³

Self-regulatory organizations have also been criticized for lax oversight of their members' activities, allowing unethical and even illegal

216. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/GGD-00-115, SECURITIES ARBITRATION: ACTIONS NEEDED TO ADDRESS PROBLEM OF UNPAID AWARDS 33 (2000).

217. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-03-162R, FOLLOW-UP REPORT ON MATTERS RELATING TO SECURITIES ARBITRATION 3 (2003).

218. BERKSON, *supra* note 172, at 2.

219. See Birdthistle & Henderson, *supra* note 2, at 8–9.

220. Jean Eaglesham, *Arbitration Awards Against Stockbrokers Go Unpaid*, WALL ST. J. (Feb. 25, 2016), <http://www.wsj.com/articles/arbitration-awards-against-stockbrokers-go-unpaid-1456376403>.

221. Jean Eaglesham & Rob Barry, *More Than 5,000 Stockbrokers From Expelled Firms Still Selling Securities*, WALL ST. J. (Oct. 4, 2013), <http://www.wsj.com/articles/SB10001424052702303643304579107442831410708>.

222. *Id.*

223. See BERKSON, *supra* note 172, at 37 ("FINRA, like the NASD before it, has remained quiet regarding the issue of unpaid awards.").

conduct to continue.²²⁴ This risk grows particularly acute when they oversee members that actively participate in the self-regulatory organization themselves. For example, Richard Whitney was not the only self-regulatory organization head to steal from widows and orphans. Bernard Madoff, a former NASD board member, ran the world's largest Ponzi scheme under FINRA's watch.²²⁵ He participated extensively in the organization, holding committee assignments and serving on the Board of Governors.²²⁶ His brother, Peter Madoff, served as the NASD's vice chairman and his son and niece also served on NASD committees.²²⁷

Industry members may cultivate lax enforcement by publicly praising a self-regulator's strength and vigor. Consider the following scenario: when an industry member successfully conceals fraud, abusive sales practices, record-keeping failures or other issues from examination staff, it has no incentive to reveal the problem and incur liability. Instead, it publicly complains about the rigor, invasiveness, and duration of the examination. This accomplishes multiple objectives. First, it fosters an impression that the particular firm must meet high standards because it overcame such an ordeal. It also provides a basis to diminish the degree of oversight in the future. Finally, and importantly, industry members—from substandard operations to the most sterling shops—face the same incentive to praise oversight's efficacy because it contributes to a positive impression about their operation.

Madoff participated in this dynamic when he praised oversight in 2007, claiming that “in today's regulatory environment, it's virtually impossible to violate rules . . . and this is something that the public really doesn't understand . . . it's impossible for a violation to go undetected.”²²⁸

The SEC's investigation into its failure to discover Madoff's Ponzi

224. Cf. Orenbach, *supra* note 56, at 153 (“In the realm of cases FINRA has actually brought, there is some reason to suspect the quality of its performance.”).

225. See Christine Hurt, *Evil Has A New Name (and A New Narrative): Bernard Madoff*, 2009 MICH. ST. L. REV. 947, 953 (2009) (describing the rise and fall of Madoff's record-shattering Ponzi scheme).

226. Steven Irwin et al., *Self-Regulation of the American Retail Securities Markets – An Oxymoron for What Is Best for Investors?*, 14 U. PA. J. BUS. L. 1055, 1075 (2012) (describing Madoff's connections to the NASD).

227. *Id.*

228. Jessica Pressler, *Bernie Madoff: 'In Today's Regulatory Environment, It's Virtually Impossible to Violate Rules,'* N.Y. MAG. (Dec. 16, 2008), http://nymag.com/daily/intelligencer/2008/12/bernie_madoff_in_todays_regula_1.html (noting that while running what was to become the largest Ponzi scheme in financial history, Madoff served in important positions within the securities industry's self-regulatory organization); see also Cheryl Nichols, *Addressing Inept SEC Enforcement Efforts: Lessons from Madoff, the Hedge Fund Industry, and Title IV of the Dodd-Frank Act for U.S. and Global Financial Systems*, 31 NW. J. INT'L L. & BUS. 637, 645 (2011) (“Madoff, along with his family, sought and obtained top-level positions in the securities industry and with regulators. Madoff was a member of the [FINRA] board of governors.”).

scheme revealed the actual weakness of FINRA's oversight.²²⁹ Members of the SEC's examination team stated that they generally found FINRA's own examination reports to be "not very helpful."²³⁰ One examiner speculated that FINRA examinations "completely missed" issues either because of "connections to the industry," incompetence, or a general check-the-box mentality.²³¹

Of course, the SEC also deserves plenty of criticism for its failures to discover Madoff's fraud.²³² It had information warranting a much more extensive investigation in 1992 but failed to connect the dots.²³³ It also failed to uncover the fraud despite receiving detailed tips from Harry Markopolos and conducting multiple subsequent examinations.²³⁴

4. Illusory Rulemaking Activity

Self-regulatory organizations may also be prone to engaging in illusory activity—actions designed to give the appearance of effort but without any real substance. For example, FINRA frequently and conspicuously claims that its "first responsibility is to investors" and that it promotes market confidence by "efficiently addressing emerging investor-protection concerns."²³⁵ As evidence of its purportedly aggressive protection of the public interest, FINRA's most recent annual report prominently touts a proposed "rule to protect seniors from financial exploitation."²³⁶

FINRA's protection of seniors and vulnerable individuals may be more illusory than real. If enacted, the celebrated rule proposal would not actually impose any significant investor protection requirements on FINRA's member firms. It would do two things: (i) require firms to attempt to identify a contact person in case of the customer's incapacity; and (ii) authorize firms to, at their sole discretion, put policies in place to put temporary holds on accounts when "there is a reasonable belief of financial exploitation" occurring.²³⁷ The proposed rule attracted

229. SEC. & EXCH. COMM'N OFFICE OF INVESTIGATIONS, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME 175–77 (2009) [hereinafter SEC INVESTIGATION].

230. *Id.* at 176.

231. *Id.*

232. See Mark Klock, *Lessons Learned from Bernard Madoff: Why We Should Partially Privatize the Barney Fifes at the SEC*, 42 ARIZ. ST. L.J. 783, 788–804 (2010) (detailing the failures in the SEC's oversight of Madoff).

233. *Id.* at 791–92.

234. *Id.* at 794.

235. FINRA, 2015 ANNUAL REPORT, *supra* note 7, at 1–2.

236. *Id.* at 2.

237. FINRA, REGULATORY NOTICE 15-37: FINANCIAL EXPLOITATION OF SENIORS AND OTHER VULNERABLE ADULTS 1 (Oct. 2015), https://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-15-37.pdf. While

comments from law school clinics with an interest in public welfare. Georgia State explained that while it supported the effort, the proposed rule gave the industry a safe harbor to keep assets within the firm without imposing any obligation to actually do anything.²³⁸ The University of Miami School of Law also asked for changes, proclaiming that the rule “creates no obligation” to do anything.²³⁹

Financial self-regulatory organizations are not the only self-regulatory bodies prone to illusory rulemaking activity.²⁴⁰ The American Bar Association’s Model Rule 6.1, states that lawyers “should aspire to render at least (50) hours of pro bono public legal services per year.”²⁴¹ The comment to the rule makes clear that the “responsibility . . . is not intended to be enforced through disciplinary process.”²⁴²

When it comes to attorneys, reputation may provide some pressure to perform pro bono services.²⁴³ The ABA Law Firm Pro Bono Challenge asks large firms to contribute a certain percentage of billable hours to pro bono service and publicizes successes and failures.²⁴⁴ While imperfect, the Challenge has been credited with an overall increase in the amount of pro bono services law firms perform.²⁴⁵ Importantly, pro bono services yield benefits to law firms as well, including positive publicity, attorney development, and the ability to recruit talented, public-minded law students by making a credible promise that they will be able to participate in pro bono opportunities. While Model Rule 6.1 imposes no obligation, the “spotlight of public pressure” fills this gap by strongly encouraging pro bono service.²⁴⁶

collecting emergency contact information will likely do much good, this small step hardly seems to warrant the fanfare.

238. E-mail from Nicole Iannarone, Assistant Clinical Professor, Chris Pugh, Jason Robinson & Darius Wood, Student Interns, Georgia State University College of Law Investor Advocacy Clinic, to Marcia E. Asquith, Corporate Secretary, FINRA (Nov. 25, 2015), http://www.finra.org/sites/default/files/15-37_georgia-state-law_comment.pdf (“[T]he Proposal also allows a Qualified Person to use their discretion to ignore a reasonable belief that financial exploitation is likely and do nothing.”).

239. E-mail from Theresa J. Verges, Director, Investor Rights Clinic, University of Miami School of Law, to Marcia E. Asquith, Corporate Secretary, FINRA (Nov. 30, 2015), http://www.finra.org/sites/default/files/15-37_University-Miami-School-Law_comment.pdf (explaining that the proposed rule “would allow a broker-dealer to *ignore* evidence of financial exploitation” without reporting the suspected exploitation or putting a hold on the account).

240. See Richard W. Painter, *Rules Lawyers Play By*, 76 N.Y.U. L. REV. 665, 726 (2001) (“The ABA and state bar associations have responded to shortages in legal services with aspirational rules.”).

241. MODEL RULES OF PROF’L CONDUCT r. 6.1 (AM. BAR ASS’N 1983).

242. See *id.* cmt. 12.

243. See Painter, *supra* note 240, at 727 (explaining that “[i]f information about compliance is widely disseminated, the rule could become a reputationally-enforced rule”).

244. See Scott L. Cummings, *The Politics of Pro Bono*, 52 UCLA L. REV. 1, 40 (2004).

245. *Id.*

246. *Id.* at 84.

FINRA's aspirational, proposed senior protection seems to have seen less success than the ABA's aspirational pro bono rule. The proposal includes no mechanism to differentiate broker-dealer firms that commit to senior-protection policies from those that do not. If anything, the proposed rule's structure creates an incentive not to take additional steps to protect seniors. Without some differentiating publicity, firms that take steps to protect seniors may simply incur costs that will not be borne by their competitors. Thus, firms that protect seniors may underperform compared to firms that do not.

As discussed below, including reputational enforcement mechanisms would increase competition without any substantial burden.²⁴⁷ FINRA's BrokerCheck system already makes reports about firms and individual brokers available. Prominently including this information in the reports might provide an adequate reputational incentive.

V. AMPLIFY THE PUBLIC'S VOICE

Most observers agree that self-regulatory organizations often struggle to protect the public's interest.²⁴⁸ Despite such common knowledge, crafting policy responses remains difficult. Jeff Gordon has explained that administrative rulemaking's traditional benefit-cost analysis approach fails to account for the unique nature of financial regulation.²⁴⁹ Consider the contrasting case of using pesticides to protect crops. In the near term, evolution proceeds so slowly that, for a reasonably foreseeable period, an administrative agency can calculate with a reasonable degree of certainty the increase in crop yields and balance it against any negative population health effects from using the pesticides. Pesticides do not suddenly become nontoxic.

The man-made financial system responds differently to regulation than a natural environmental system. It does not operate according to the laws of nature, but rather the rules of the financial system.²⁵⁰ When the financial system's rules change, industry members adapt rapidly and may fundamentally restructure their transactions.²⁵¹ Adaptation and change occur so rapidly that it may be impossible to predict the eventual benefits and costs of a proposed financial regulation.²⁵²

247. See text accompanying note 260.

248. See note 197.

249. Jeffrey N. Gordon, *The Empty Call for Benefit-Cost Analysis in Financial Regulation*, 43 J. LEGAL STUDIES 351, 375 (2014).

250. See *id.* at 352 ("For the financial sector, the system that generates costs and benefits is not a natural system but rather a system constructed by the pattern of financial regulation itself and by the subsequent processes of adaptation and regulatory arbitrage.").

251. *Id.*

252. *Id.* at 352-53.

Given these challenges, the best regulatory approach may be to proceed with core normative principles in mind.²⁵³ Because self-regulatory organizations struggle to protect the public interest, effective structural reforms will elevate the public interest within these organizations.²⁵⁴

Insights into addressing the problem emerge by looking at it through the lens of Albert O. Hirschman's classic "exit, voice, and loyalty" typology.²⁵⁵ The seminal text describes the different ways consumers, shareholders, or citizens express their displeasure at organizational choices. Exit and voice provide the two primary mechanisms for expressing displeasure. For example, putting judicial ethics to the side, Justice Ruth Bader Ginsburg used her "voice" to express displeasure when she characterized Donald Trump as a "faker,"²⁵⁶ and referenced the "exit" option when she said that his election might call for a "move to New Zealand."²⁵⁷ While dissatisfied shareholders may sell their holdings and "exit" if they dislike management decisions, the public lacks any meaningful mechanism to "exit" financial regulation. Similarly, the public's voice in the process is particularly muted within self-regulatory organizations that are well-insulated from the political process.

Amplifying the public's voice may alter the behavior of self-regulatory organizations. The general idea has been accepted for some time. Other academics have called to include public representatives in self-regulatory processes.²⁵⁸ The industry accepts this premise as well. In a rear-guard action to ward off regulation, the NYSE first began to include hand-selected, purportedly public members after the Great Depression. Still, a greater focus on amplifying the public voice in the process may yield

253. *See id.* at 374 ("[C]ritical judgments ought to not to be made on the basis of [benefit-cost analysis] but rather in light of normative principles that the regulator is prepared to defend as undergirding a sound financial system and that may be in competition with one another.").

254. Adam Levitin has recognized that changes to regulatory structure has previously been embraced to improve regulatory performance. *See* Adam J. Levitin, *The Politics of Financial Regulation and the Regulation of Financial Politics: A Review Essay*, 127 HARV. L. REV. 1991, 2054 (2014) ("Rather than returning financial regulation to the ballot box, a second approach to the capture problem has been to pursue targeted changes in the architecture of financial regulation to attempt to mitigate capture."); *accord* Judge, *supra* note 21, at 640 ("[S]tructural reforms that reduce the magnitude of the advantages that entrenched intermediaries typically enjoy may also reduce intermediary influence.").

255. *See generally* ALBERT O. HIRSCHMAN, EXIT VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 4, 77 (1970) (describing the roles of exit, voice, and loyalty on the part of shareholders).

256. Editorial, *Donald Trump Is Right About Justice Ruth Bader Ginsberg*, N.Y. TIMES (July 13, 2016), http://www.nytimes.com/2016/07/13/opinion/donald-trump-is-right-about-justice-ruth-bader-ginsburg.html?_r=0 (arguing that "Justice Ruth Bader Ginsberg needs to drop the political punditry and the name-calling").

257. *Id.*

258. *See* Omarova, *supra* note 204, at 635 (calling for participation from public interest representatives alongside regulators and industry). Ian Ayers and John Braithwaite have argued that empowered public interest groups may mitigate regulatory capture; *see also generally* IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE (1992).

significant additional benefits by providing a countervailing force to balance against industry interests.

This approach, however, will not solve all problems. Self-regulatory organizations will continue to fail to protect the public's interest in many situations. Still, amplifying the public's voice may lead to swifter action than would naturally stem from governance regimes without meaningful public input.

A range of possible policy responses may amplify the public's voice in the self-regulatory process. Substantial improvements may be gained by addressing known weaknesses with the existing processes to institutionalize the public's voice in self-regulatory organizations. While incremental reforms will not eliminate all issues, they will advance core normative principles. This section suggests reforms to amplify the public's voice from the inside, outside, and above.

A. Inside: Public Appointment Processes

Consider the current use of public representatives. Self-regulatory organizations have long claimed to include the public's voice inside their governance process. In most instances, reforms giving the appearance of public voice were implemented in response to past scandals and failures. For example, the NYSE first added three purportedly public members to its board after the Great Depression in an attempt to head off more substantive reforms.²⁵⁹ The tradition continued with the NASD moving to a majority public board after the odd-eighths scandal.²⁶⁰

Longstanding concern about the ability of industry to "capture" the public representatives on self-regulatory boards appears justified. For example, the Massachusetts Securities Division, one of the most vigilant state securities divisions, argued in 2007 at FINRA's birth that the self-regulator would be "fundamentally flawed if the representatives of investors are chosen directly or indirectly by the securities industry or the current" self-regulatory associations.²⁶¹

At present, it appears that the securities industry indirectly selects the investor representatives that serve on FINRA's board as Public Governors. Public Governors are appointed by the FINRA "Board from

259. *See supra* notes 46, 47.

260. *See* SEC, 21A Report, *supra* note 142, at 4 ("The NASD reorganized to provide for a Board of Governors which includes a majority of non-industry members.").

261. Comment Letter from William F. Galvin, Secretary of the Commonwealth of Massachusetts, to Nancy M. Morris, Secretary, Securities and Exchange Commission (Apr. 18, 2007), <https://www.sec.gov/comments/sr-nasd-2007-023/nasd2007023-73.pdf> ("We specifically recommend that bodies like the North American Securities Administrators Association, the American Association of Retired Persons, and the Consumer Federation of America be among the investor advocates who select the Public Governors . . .").

candidates recommended to the Board by the Nominating Committee.”²⁶² Under the bylaws, the “number of Public Governors on the Nominating Committee shall equal or exceed the number of Industry Governors on the Nominating Committee.”²⁶³ While FINRA does not publish the names of the Governors serving on the nominating committee, the bylaws permit the industry to have an equal voice in selecting Public Governors. Because of this structure, a single industry-aligned Public Governor on the Nominating Committee may give industry representatives control over the Public Governor nomination process.

Self-regulatory organizations could more credibly commit to incorporating the public’s voice in their governance by moving the appointment process for public representatives outside of the organization. The Public Company Accounting Oversight Board (PCAOB) provides an illustrative example of how to structure the appointment process for a self-regulatory organization’s leadership.²⁶⁴ Congress created the PCAOB after a series of accounting scandals, and granted the SEC authority to appoint the leadership of the PCAOB.²⁶⁵ While controversial, the Supreme Court upheld the appointment structure, so long as the PCAOB’s members were removable at will.²⁶⁶ While the PCAOB has its critics, John Coffee has praised it for outshining other self-regulatory organizations supervised by the SEC.²⁶⁷

Altering the appointment process for Public Governors to FINRA’s Board of Governors may generate different results and amplify the public’s voice within the organization. At the least, it would provide a limited check by reducing the ease with which industry-elected members of the Board of Governors may appoint tame public representatives. A number of different institutions would likely generate better appointment results than the status quo. Public representatives could be appointed by a cross-section of existing federal agencies and investor protection

262. FINRA, BY-LAWS OF THE CORPORATION ART. VII, § 5.

263. FINRA, BY-LAWS OF THE CORPORATION ART. VII, § 9(b).

264. See 15 U.S.C. § 7211 (2012) (creating the PCAOB).

265. See *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477, 484 (2010) (“The Board is composed of five members, appointed to staggered 5-year terms by the Securities and Exchange Commission.”).

266. *Id.* at 510. Notably, the Supreme Court struck down the portion of Sarbanes-Oxley insulating the PCAOB’s members from removal. For a discussion on this point, see Dina Mishra, *An Executive-Power Non-Delegation Doctrine for the Private Administration of Federal Law*, 68 VAND. L. REV. 1509, 1569 (2015) (“PCAOB therefore extended a removability-at-will requirement to the PCAOB members, a set of inferior executive officers who were removable only by for-cause-protected principal officers.”).

267. See John C. Coffee, Jr., *Backstabbing in Washington: The Curious Case of the PCAOB*, COLUMBIA BLUE SKY BLOG (Sept. 21, 2015), http://clsbluesky.law.columbia.edu/2015/09/21/backstabbing-in-washington-the-curious-case-of-the-pcaob/#_edn2 (“[A]mong the SEC and its network of subordinate SROs, only the PCAOB has come up with a coherent strategy for stressing individual accountability (namely, disclosing the identity of the engagement partner).”).

nonprofits. For example, superior public representatives might emerge if appointed by a mix of the Consumer Financial Protection Bureau (CFPB), SEC, the North American Securities Administrators Association, Department of Justice, Department of Labor, and Department of Veterans Affairs. All of these institutions, agencies, and organizations have a strong interest in investor protection and retirement security.

Dispersed appointment responsibilities also may do some good. Dispersing the appointment power for public representatives would increase the likelihood that a self-regulatory organization's board will incorporate a variety of views.²⁶⁸ It may also make it more difficult for an industry to effectively control the appointment process; instead of needing to gain control of one public representative on the Nominating Committee, coordinated industry interests seeking to capture the slate would need far broader influence. Furthermore, attempts to gain this influence might be mitigated by other groups battling for the attention of federal agencies. For example, the financial services industry might find labor activists also vying to influence the Department of Labor.

B. Outside: Increased Transparency

While changes to the appointment process would amplify the public's voice from within self-regulatory organizations, increased transparency would improve outside monitoring of self-regulatory organizations. For example, outside actors often struggle to bring pressure to bear on self-regulatory organizations because they cannot obtain information.²⁶⁹ Transparency can be increased through modest reforms.

1. Public Reporting

Public reporting offers significant benefits. Transparency could be significantly increased by requiring FINRA and other self-regulatory organizations to make public disclosures similar to those made by public companies. The Exchange Act requires publicly traded companies to file annual reports that disclose significant amounts of information. These disclosures then appear on the SEC's website in a standardized format that allows for easy access to relevant information.²⁷⁰ At present, FINRA does not operate in the same disclosure structure, making it difficult for

268. Cf. Solomon, *supra* note 71 (“What perhaps would work, though, would be to foster a diversity of backgrounds and views among regulators.”).

269. See Fisch, *supra* note 167, at 800 (“[F]ew of the details of FINRA's investigations, its disciplinary actions, and even its customer arbitrations are transparent.”).

270. See *EDGAR: Company Filings*, SEC <https://www.sec.gov/edgar/searchedgar/companysearch.html> (last visited July 16, 2016).

the public to gain insight into its operations or about the backgrounds of the public representatives serving on its board. Public companies publish information about company directors including, among other things, information about their business experience and any other relatively recent directorships they have held.²⁷¹ When a public company director departs under unusual circumstances, the SEC's rules often require companies to provide the public with information indicating the reasons for the departure.²⁷² FINRA does not operate under similar reporting requirements and need not release any information when a public governor departs its board.

Posting information to the SEC's website would also limit FINRA's ability to edit reports after issuance. Consider the issues that emerged after a draft version of this Article appeared on the Social Science Research Network. One version of FINRA's 2015 Annual Report listed Robert W. Scully as a public governor as of June 15, 2016.²⁷³ After realizing that it had not disclosed accurate information about the composition of its board as of that date, FINRA simply modified the previously released annual report to omit Mr. Scully's name.²⁷⁴ A requirement that FINRA and other self-regulatory organizations disclose information through the SEC's disclosure portal would alert the public about material changes because alterations would be accomplished through the filing of an amended annual report instead of simply modifying the contents of a previously issued report.

2. Limited Access to Information About SEC Oversight

One recent case illustrates the difficulty outside groups experience when seeking information about processes at self-regulatory organizations. The Public Investors Arbitration Bar Association (PIABA), a nationwide bar association of investor advocates, sought information from the SEC about its oversight of FINRA's arbitration process.²⁷⁵ Because FINRA is not subject to the Freedom of Information

271. 17 C.F.R. § 229.401(e) (Lexis, Lexis Advance through the Mar. 29, 2017 issue of the Federal Register) (“Briefly describe the business experience during the past five years of each director . . .”).

272. See SEC, *Instructions to Form 8-K*, Item 5.02(a)(iii) (requiring public companies to provide “a brief description of the circumstances representing the disagreement that the registrant believes caused, in whole or in part, the director’s resignation, refusal to stand for re-election or removal”).

273. See Benjamin P. Edwards, *Selecting the Public’s Representatives in the Financial Regulatory Process*, PRAWFSBLAWG (Aug. 26, 2016), <http://prawfsblawg.blogs.com/prawfsblawg/2016/08/selecting-the-publics-representatives-in-the-financial-regulatory-process.html>.

274. *Id.*

275. See *Pub. Invest. Arb. Bar Ass’n v. U.S. SEC*, 930 F. Supp. 2d 55 (2013), *aff’d* 771 F.3d 1 (2014) [hereinafter PIABA I].

Act (FOIA) as it is not a government entity, PIABA sought “records related to the SEC’s oversight” of FINRA.²⁷⁶ The SEC identified 65 boxes of potentially responsive materials in response to the request but declined to produce any of them under a FOIA exemption.²⁷⁷

Government agencies do not always provide all information sought in FOIA requests. There are nine different exemptions that allow federal agencies to refuse to disclose documents in response to FOIA requests.²⁷⁸ The SEC identified Exemption 8, which provides that federal agencies need not produce information “related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions.”²⁷⁹ At the present, FINRA qualifies as a financial institution under an odd Exchange Act definition that Congress tweaked in an attempt to protect the records of financial institutions while preventing the SEC from covering up its Madoff-related oversight failures.²⁸⁰ This means that the SEC does not need to disclose information to the public about its oversight of FINRA or any other self-regulatory organization.²⁸¹

In most instances, Exemption 8 serves a useful purpose. The exemption allows financial institutions to communicate with their regulators without fearing that “their confidential information will be disclosed.”²⁸² Absent this sort of protection, financial institutions might resist basic information requests for fear that answering a regulator’s questions would mean the publication of internal business affairs.

The traditional rationale applies with much less force to the SEC’s hesitation in sharing its oversight practices of industry self-regulatory organizations. Remarking on the oddity, the district court explained that it was “skeptical that a self-regulatory organization like FINRA would logically qualify as a ‘financial institution’ as that term has traditionally been defined or . . . understood.”²⁸³ Despite this oddity, the court found that while the “plaintiff may be correct that Exemption 8 is overbroad because it extends to records related to the oversight of self-regulatory organizations, . . . there is no escaping the conclusion that Congress has left no room for a narrower interpretation.”²⁸⁴ Given the statute’s text, the court explained that PIABA would need to direct its arguments “at

276. *Id.* at 58.

277. *Id.* at 60.

278. *See* 5 U.S.C. § 552(b) (2012).

279. *Id.* § 522(b)(8).

280. *See PIABA I*, 930 F. Supp. 2d at 67–70.

281. *Id.*

282. *Bloomberg, L.P. v. U.S. SEC*, 357 F. Supp. 2d 156, 170 (D.D.C. 2004).

283. *PIABA I*, 930 F. Supp. 2d at 69.

284. *Id.* (internal citations and quotations omitted).

Congress, rather than the courts,” even though the amendments had resulted in “unintended consequences.”²⁸⁵

On appeal, the D.C. Circuit affirmed, also concluding that Exemption 8 swept broadly and effectively exempted examination and oversight information related to any entity the SEC regulates, including self-regulatory organizations.²⁸⁶ Despite agreeing with this reading of the statute, Judge Brown crafted a striking concurrence and called for Congress to “revisit this ill-conceived amendment” that defined financial institutions as anything under the SEC’s oversight.²⁸⁷

3. Increase Access to Information

Either Congressional action or SEC rulemaking could amplify the public’s voice by providing more access to information. Transparency also provides significant benefits. It would subject self-regulatory organizations to more constant public scrutiny, increasing the likelihood that they will act in the public’s interest.²⁸⁸

Congress could also create additional transparency by revisiting FOIA’s exemptions. A more tailored structure could protect the sensitive financial information of true financial institutions while allowing for the public to review information about the SEC’s oversight of self-regulatory organizations. For example, information about the SEC’s oversight of FINRA’s process for appointing Public Governors would likely have informed the preceding analysis.

Of course, not all transparency initiatives must come from Congress. The SEC could require FINRA to make more information more readily available to the public, news organizations, and academics. At present, FINRA often limits access to information of public concern. For example, the Wall Street Journal aggregated information to identify geographic locations with clusters of problem brokers.²⁸⁹ Because FINRA refuses to provide access to broker data in bulk, the Journal painstakingly “filed public-records requests with all 50 state securities

285. *Id.* at 69–70.

286. *See* Pub. Invest. Arb. Bar Ass’n v. U.S. SEC, 771 F.3d 1, 7 (2014) (explaining that “documents the Commission collects while examining financial institutions—that is, while examining any organization the agency regulates—are exempt from disclosure”) [hereinafter PIABA II].

287. *Id.* at 10 (Brown, J., concurring) (further providing that “[i]t bodes ill for rebuilding civic trust that Exemption 8 could be employed to permanently shroud both the possible reckless conduct by regulated financial institutions and the particulars of sweeping agency intrusions into the sphere of the financial marketplace”).

288. *See* Reiss, *supra* note 175, at 608 (“A less-noticed agency may feel more comfortable allowing industry to deviate from the public interest than one that is under scrutiny.”).

289. Jean Eaglesham & Rob Barry, *How Troubled Brokers Cluster, Often Among Elderly Investors*, WALL ST. J. (Nov. 12, 2014), <http://www.wsj.com/articles/how-troubled-brokers-cluster-often-among-elderly-investors-1415763019>.

regulators” to gain access to information held within a single FINRA-maintained database.²⁹⁰

Researchers have also complained about FINRA’s refusal to allow access to data. The authors of one study characterized as misleading FINRA’s claims of allowing access to information about 1.2 million stockbrokers.²⁹¹ While FINRA does allow investors to view a limited subset of information on file about particular stockbrokers, it “actually goes to great lengths to make information which is ostensibly public, effectively non-public” by making it difficult to aggregate data.²⁹²

While the discussion has focused on FINRA, the need for additional transparency extends to other self-regulatory organizations. Similar problems also plague the derivatives market oversight by the Commodities Futures Trading Commission (CFTC).²⁹³

C. Above: Enhanced SEC Oversight

The public’s voice might also be amplified by enhanced oversight from the SEC. While the SEC faces significant resource constraints, some action lies within its power to address the problems detailed here. For example, the SEC might do much good by using its oversight role to intervene when self-regulatory bodies engage in illusory activity.

Reputational enforcement mechanisms could create an incentive for firms to comply with aspirational standards and rules. At present, FINRA’s proposed senior and vulnerable-adult rules do not actually require any industry firms to do anything to protect anyone when they become aware of financial exploitation.²⁹⁴ These proposals would be substantially improved if they also created some sort of reputational enforcement mechanism, such as a scorecard or additional disclosures on the BrokerCheck Reports of the registered representatives affiliated with FINRA member firms.

Consider the competitive benefits if FINRA and its member firms were required to publicize whether they actually create and agree to be bound by policies designed to protect senior citizens. A BrokerCheck Report

290. *Id.*

291. See McCann et al., *supra* note 121, at 4–5.

292. *Id.* at 3. (calling for FINRA to “make BrokerCheck information truly publicly available and allow rating companies . . . and news outlets . . . to rank brokerage firms on the risk of fraud”); see also generally Randall K. Johnson, *Why We Need A Comprehensive Recording Fraud Registry*, 2014 N.Y.U. J. LEGIS. & PUB. POL’Y QUORUM 88 (2014) (finding that U.S. government agencies that provide greater access to public information may deter more misconduct than other agencies).

293. See Derek Fischer, *Dodd-Frank’s Failure to Address CFTC Oversight of Self-Regulatory Organization Rulemaking*, 115 COLUM. L. REV. 69, 108 (2015) (arguing that CFTC oversight of SROs could be improved by disclosure requirements).

294. See text accompanying notes 235 to 246.

indicating that a particular associated person worked for a firm that opted out of providing senior citizen protections could provide a valuable data point for a customer. To the extent that these reforms actually protect seniors and vulnerable adults, the public would likely benefit from being able to differentiate the firms that implement these policies from those that do not. If senior-protecting firms advertised their policies or received public recognition for the move, it would provide a competitive advantage, justifying the outlay of resources. At present, FINRA's proposed rule does not create that incentive.

VI. IMPLICATIONS AND ALTERNATIVES

As discussed above, calculating the future impact of financial regulation may be impossible because the financial system changes much more rapidly and dramatically than any natural system.²⁹⁵ Still alternatives and implications must be considered. This Part briefly responds to potential objections.

A. Diminished Expertise?

Appointing public representatives without significant industry connections may come at some cost. Without some connection to the industry, FINRA's Public Governors may lack the expertise to function effectively in their role. The roster of qualified candidates might shrink dramatically if FINRA were to limit itself to persons that had never served within the industry.

Finding qualified candidates with less apparent conflicts may require some work. Still, it seems likely that sufficiently qualified candidates without the sorts of conflicts and relationships detailed above may be found. For example, the North American Securities Administrators Association might be able to suggest current former or state securities regulators with sufficient expertise and without deep, entangling industry connections. It should also be possible to draw from former industry members without needing to resort to candidates that concurrently serve on the boards of financial institutions. Similarly, investor advocates with a history of successfully challenging the industry for abusive sales practices might make strong candidates for an organization devoted to investor protection.

In any event, offloading the Public Governor appointment process to other institutions would reduce that possibility that current industry members would use existing processes to ensure the appointment of pliant

295. See Gordon, *supra* note 249.

public representatives.

B. Abolish FINRA?

The voice-amplifying proposals advanced above might also be criticized for their modest approach. Given the long history of scandals and failures detailed above, it may seem better to simply start anew and create an entirely new, entirely public regulatory apparatus.

While this proposal has some merit, it seems both unlikely and unwise. From a public-cost perspective, it seems unlikely that the current Congress will create sustained funding for the SEC sufficient to enable it to entirely absorb FINRA's regulatory responsibilities. Without public willingness to fund regulation and oversight, an entirely public model might perform even worse than the current self-regulatory model.

Radical reforms also create risk. While this Article takes a generally critical view, the self-regulatory model has generated a well-functioning, albeit costly, securities market. Given the capital market's central importance to the world economy, gradual tinkering is likely superior to sudden reforms. Any potentially destabilizing regulatory intervention might provide a cure worse than the disease.

VII. CONCLUSION

This Article proposes amplifying the public's voice in the self-regulatory process through a variety of mechanisms, including governance, transparency, and enhanced governmental oversight. While these incremental reforms seem likely to dramatically alter institutional behavior, their adoption and implementation must be guided by a focus on long-term public's interest in financial regulation.

Structures that amplify the public's voice in pursuit of the public interest would do much to limit the dark side of self-regulation. For better or worse, the self-regulatory system seems entrenched into the fabric of the modern financial markets. Disbanding self-regulatory organizations might do significant short-term harm. It also appears unlikely that Congress would credibly commit to sustained public funding for oversight of the financial markets. Given FINRA's important position, governance reforms aimed at increasing its public mindedness and sympathy to public concerns may offer the best option for altering its behavior. Ultimately, FINRA wields power and authority entrusted to it by Congress and the public. It should remain responsive to public concerns.