The Financial Industry Regulatory Authority: Not Self-Regulation after All

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Abstract

Broker-dealers in the United States are regulated by the Financial Industry Regulatory Authority (FINRA). Although commonly perceived to be a self-regulator, FINRA is not accountable to the industry in the way a self-regulator would be. Nor is it accountable to the public, Congress, the president, or the courts. FINRA's structure and monopoly status shield it from close oversight. Consequently, an important part of the securities markets is under the control of a regulator with limited accountability. As FINRA seeks to expand its regulatory footprint into areas such as investment adviser regulation, its unique form of regulation warrants reconsideration.

JEL codes: G1, G2, G3, H1, K2

Keywords: broker-dealers, self-regulation, securities regulation, securities markets, Securities and Exchange Commission, Financial Industry Regulatory Authority, FINRA, government accountability, financial regulation, regulatory process

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The Financial Industry Regulatory Authority

Not Self-Regulation after All

Hester Peirce

The Financial Industry Regulatory Authority (FINRA) is the front-line regulator of broker-dealers in the United States. FINRA is not the self-regulatory organization (SRO) some imagine it to be. A self-described independent regulator, FINRA is a nongovernmental, not-for-profit organization that wields considerable governmentally enforced control over the daily activities of its member firms, their employees, and the investors they serve. On the one hand, its governance structure means that it is not accountable to the industry it regulates the way an SRO would be. On the other hand, FINRA's broad, governmental powers are not paired with the public accountability measures to which government regulators are subject. Concerns about FINRA's lack of accountability loom even larger as FINRA seeks to regulate additional facets of the financial markets such as investment advisers and securities markets. Policymakers should reconsider its growing role in light of its lack of accountability to the industry it regulates and to the public it is supposed to serve.

This paper proceeds as follows. Section 1 discusses the history and responsibilities of FINRA and its predecessor, the National Association of Securities Dealers (NASD). Section 2 discusses FINRA's current functions. Section 3 sets forth the structure of accountability within which FINRA operates. Section 4 compares the mechanisms by which government regulators are held accountable to the public with FINRA's accountability structure. Section 5 discusses recent changes in FINRA's focus and aspirations. Finally, the paper concludes with a recommendation that FINRA's role in the regulation of the US securities markets be reconsidered in order to achieve more effective and accountable financial regulation.

1. The Emergence of FINRA

The self-regulatory tradition of the securities industry, under which industry participants collaborate to set and enforce standards of conduct, is well established. Self-regulating securities exchanges were already the industry norm when Congress created the Depression-era federal securities framework. Exchanges regulated member conduct and market activity and set standards for listed companies.[1] The Securities Exchange Act of 1934[2] (Exchange Act) recognized and relied on exchange SROs, such as the New York Stock Exchange (NYSE), to continue performing these regulatory functions under the watch of the US Securities and Exchange Commission (SEC)—the governmental regulator of the securities markets. FINRA's predecessor, the NASD, joined the ranks of SROs in the late 1930s.

Before the Exchange Act reached its fifth birthday, its self-regulatory provisions were expanded beyond the exchange-traded markets to include the over-the-counter (OTC) markets. Before this expansion, brokers working in OTC markets were not regulated by an SRO. Instead, in 1934, President Franklin D. Roosevelt approved a code of fair competition under the National Industrial Recovery Act (NIRA). Privately developed by the securities industry, the code became legally binding on the industry through the president's action.[3] The Supreme Court soon thereafter ruled NIRA unconstitutional,[4] and the securities industry code lost its legal force.

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[1] For a history of securities markets SROs, see Kenneth Durr and Robert Colby, *The Institution of Experience: Self-Regulatory Organizations in the Securities Industry, 1792–2010* (Washington, DC: Securities and Exchange Commission Historical Society, 2010), http://www.sechistorical.org/museum/galleries/sro.

[2] 15 U.S.C. § 78a et seq. (2012).

[3] John D. McGowan, "The NASD: Origins, Recent Developments, and Future Goals" (manuscript, 1974), 8–10, http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1970/1974_0801_NASDOriginsT.pdf.

[4] Schecter Poultry Corp. v. United States, 295 US 495, 541–42 (1935), holding that "code-making authority thus conferred is an unconstitutional delegation of legislative power."

After NIRA's demise, the SEC worked with industry representatives to fill the void. These efforts culminated in convincing Congress to pass the Maloney Act[5] in 1938.[6] The Maloney Act added the new section 15A to the Exchange Act to allow any association of brokers or dealers meeting the statutory requirements to register with the SEC as a national securities association.[7] To register, an association had to have rules that ensured, among other things, (a) "fair representation of its members," (b) "equitable allocation of dues," (c) prevention of "fraudulent and manipulative acts and practices," (d) prevention of "unreasonable profits or unreasonable rates of commissions or other charges," (e) promotion of "just and equitable principles of trade," (f) appropriate member discipline, and (g) protection of "investors and the public interest."[8]

The Maloney Act's voluntary national securities associations were to be the OTC market counterparts to the exchange SROs. As the SEC explained shortly after the act's passage, the act embodied "the principle of conferring upon regulatory groups from business a primary responsibility for enforcing high standards of business conduct upon their members . . . [by setting] up a system of regulation in the over-the-counter markets through the formation of voluntary associations of investment bankers, dealers and brokers doing business in these markets under appropriate governmental supervision."[9] SEC Commissioner George Mathews predicted that the Maloney Act would serve as the basis for a long and productive shared regulatory relationship between the SEC and the industry:

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[5] Pub. L. No. 75-719, 52 Stat. 1070 (1938).
[6] Durr and Colby, *Institution of Experience*.
[7] 15 U.S.C. § 78o-3 (2012).
[8] Id. at § 78o-3(b) (1940).
[9] SEC, *Fourth Annual Report of the Securities and Exchange Commission: Fiscal Year Ended June 30, 1938* (Washington, DC: SEC, 1938), 33.

> The cooperative program envisioned in the Act must of necessity be an evolutionary one. Ideally, the industry should eventually play the predominant role in its own regulation and development along sound economic and social lines. . . . As spokesmen for the Commission have repeatedly said, it is sincerely to be hoped that the ultimate role of the Commission will be a residual one in which its energies may be principally directed toward dealing with the submarginal element known to all industries which in the absence of coercion refuses to abide by either moral or legal standards. Admittedly, the fulfillment of this ideal requires time.[10]

A year later, the first step in the evolution began when the SEC approved FINRA's predecessor, the NASD, to be the first registered national securities association. Because no other associations had registered with the SEC, the NASD was the only SRO for brokers and dealers in the OTC markets.[11] In 1945, the NASD began requiring principal and customer-facing employees of broker-dealers to register with the NASD.[12]

In the early 1960s, the SEC recommended making NASD membership mandatory.[13] Instead, in 1964, Congress gave the SEC the authority to establish a regulatory framework for broker-dealer firms in the OTC securities markets that were not NASD members.[14] Under this authority, the SEC set up the so-called SEC-Only (SECO) program. In 1983, NASD membership became mandatory through legislation resulting from "a joint effort with the NASD" that "abolished the SECO program, under which the Commission staff has been

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[10] George C. Mathews, "A Discussion of the Maloney Act Program" (address before the annual convention of the Investment Bankers Association of America, White Sulphur, WV, October 23, 1938), 2, http://www.sec.gov/news/speech/1938/102338mathews.pdf.

[11] The National Futures Association subsequently registered as a limited-purpose national securities association because of new regulatory powers over security futures products it acquired under the Commodity Futures Modernization Act of 2000. National Futures Association, "The Value of Building Strong Relationships," *News Facts Actions* 19, no. 1 (2001), http://www.nfa.futures.org/news/newsLetterArticle.asp?ArticleID=535.

[12] For a contemporaneous discussion of the requirement, see Wallace H. Fulton, "Executive Director's Report," *NASD News* 7, no. 1 (1946): 3, http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1940/1946_0201_NASDNews.pdf.

[13] Hugh F. Owens, "The Securities Acts Amendment and the Investment Banking Community" (address before the Texas Group Investment Bankers Association of America, San Antonio, TX, April 8, 1965), 7, http://www.sec.gov/news/speech/1965/040865owens.pdf.

[14] Pub. L. 88-467, 78 Stat. 565 (1964) (section 6 amended section 15 of the Exchange Act).

directly supervising and inspecting 600 over-the-counter firms."[15] The SEC staff later explained why the SEC recommended that Congress replace the SECO program with mandatory NASD membership:

> The Commission concluded that a direct regulatory program was not the most efficient use of the Commission's resources and that weak links in the program regarding rulemaking and data collection could not be improved without increased expenditures. The Commission determined that the benefits of retaining the SECO Program were minimal compared to the benefits to be derived from its elimination. The Commission noted that even if the program were abolished, the Commission would still retain general oversight authority over SRO actions. Because all its rules would be reviewed by the Commission, specific complaints concerning NASD performance would also be heard.[16]

The decision to eliminate the SECO program and shift more responsibility to the NASD came after changes made by Congress in 1975 had taken hold. The 1975 amendments to the Exchange Act reflected Congress's mixed conclusion that "the securities industry's unique system of self-regulation has shown great strength in some areas and, in general, has served the industry well [but] has also displayed serious deficiencies and has not operated as effectively or fairly as it should."[17] Among other things, the 1975 amendments resolved the "continuing controversy as to the precise scope of the SEC's power to amend the rules of a self-regulatory organization [by giving] the SEC clear authority to amend any self-regulatory organization's rules in any respect consistent with the objectives of the Exchange Act."[18] By making this change and requiring SEC approval for SRO rules, the 1975 amendments "greatly broadened the

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[15] SEC, *49th Annual Report of the Securities and Exchange Commission for the Fiscal Year Ended September 30, 1983* (Washington, DC: SEC, 1984), vi, https://www.sec.gov/about/annual_report/1983.pdf.
[16] Division of Market Regulation, SEC, *Market 2000: An Examination of Current Equity Market Developments* (Washington, DC: SEC, 1994), VI-6, https://www.sec.gov/divisions/marketreg/market2000.pdf.
[17] Committee on Banking, Housing, and Urban Affairs of the US Senate, *Summary of Principal Provisions of the Securities Act Amendments of 1975 S. 249* (Washington, DC: Government Printing Office, 1975), 4, http://www.sechistorical.org/collection/papers/1970/1975_0101_SummaryAmendments.pdf.
[18] Id. at 8.

Commission's authority over the SROs, and generally produced a much more substantial nexus between the Commission and the SROs."[19]

The SEC exercised its authority over the NASD in a very public way in the mid-1990s in connection with the NASD's ownership of the National Association of Securities Dealers Automated Quotations (NASDAQ) electronic stock market. The NASD created NASDAQ in 1971, and by 1994, NASDAQ had "surpasse[d] the NYSE in yearly share volume."[20] In 1996, the SEC censured the NASD for failing to enforce its rules against NASDAQ market makers participating in anticompetitive pricing practices.[21] The offending practices included coordination to manipulate prices, harassment of nonconforming market makers, unauthorized sharing of customer order information, selective failures to honor quotes, and delayed trade reporting.[22] The SEC found that "the consequences for the NASDAQ market of this failure were exacerbated by the undue influence exercised by NASDAQ market makers over various aspects of the NASD's operations and regulatory affairs."[23]

Explaining that "while self-regulation benefits from the knowledge, insight, and expertise brought by industry participants, it must give primacy to the fundamental purpose of regulation of the securities markets: the protection of investors and the public interest,"[24] the SEC required the NASD to agree to certain undertakings. Those undertakings included increasing the role of public members on the NASD board, augmenting staff autonomy and independence, chairing its

[19] Richard L. Stone and Michael A. Perino, "Not Just a Private Club: Self-Regulatory Organizations as State Actors When Enforcing Federal Law," *Columbia Business Law Review* 1995, no. 2 (1995): 461.
[20] NASDAQ, "NASDAQ OMX Corporate Timeline," accessed April 3, 2014, http://www.nasdaqomx.com/aboutus/company-information/timeline.
[21] SEC, "Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market," SEC, Washington, DC, August 8, 1996, 4, http://www.sechistorical.org/collection/papers/1990/1996_0808_SECNASD_1.pdf.
[22] Id. at 2–3.
[23] Id. at 4.
[24] Id. at 44.

disciplinary hearings with professional staff, and adopting uniform guidelines to govern membership applications and regulatory activities.[25] Barbara Black, professor of law at the University of Cincinnati College of Law, points to the NASD's 1996 settlement with the SEC as an important milestone in "the NASD's transformation into a professional regulator largely independent of its membership."[26] In 2000, NASDAQ members voted to separate NASDAQ from the NASD and establish it as a publicly held, for-profit company.[27] In 2006, NASDAQ gained exchange status.[28]

Against the backdrop of the NASD's manifest conflicts of interest in connection with the NASD's ownership of NASDAQ, US securities markets were undergoing other important changes that led Congress, the SEC, and industry to consider the need for changes to the SRO model.[29] Concerns about conflicts of interest were not limited to the NASD. Exchanges were also SROs, and there was concern that "the interests required of an SRO to regulate itself and its members are in conflict with its interests in promoting itself."[30] Those concerns intensified as exchanges started to demutualize and become for-profit entities. Most notably, the NYSE merged with Archipelago—a major electronic market—and became a publicly traded company

[25] Id. at 44–45.
[26] Barbara Black, "Punishing Bad Brokers: Self-Regulation and FINRA Sanctions," *Brooklyn Journal of Corporate, Financial, and Commercial Law* 8, no. 1 (2013): 36.
[27] NASDAQ, "NASDAQ OMX Corporate Timeline."
[28] Ibid.
[29] See, for example, *Self-Regulatory Organizations: Exploring the Need for Reform, Hearing before the Subcommittee on Capital Markets, Insurance, and Government Enterprises of the Committee on Financial Services of the US House of Representatives*, 109th Cong., 1st Session (November 17, 2005) (hereinafter "SRO Hearing"); SEC, Concept Release Concerning Self-Regulation, 69 Fed. Reg. 71256–82 (2004) (hereinafter SEC SRO Concept Release); SEC, Fair Administration and Governance of Self-Regulatory Organizations; Disclosure and Regulatory Reporting by Self-Regulatory Organizations; Recordkeeping Requirements for Self-Regulatory Organizations; Ownership and Voting Limitations for Members of Self-Regulatory Organizations; Ownership Reporting Requirements for Members of Self-Regulatory Organizations; Listing and Trading of Affiliated Securities by a Self-Regulatory Organization, 69 Fed. Reg. 71126–254 (2004); Securities Industry Association, "White Paper: Reinventing Self-Regulation," January 5, 2000 (updated October 14, 2003), http://www.sifma.org/workarea/downloadasset.aspx?id=21354.
[30] Securities Industry Association, "White Paper," 8.

in March 2006.[31] The changes raised concerns from some quarters about whether the for-profit NYSE could effectively manage the arguably "conflicting goal of having to maximize profits while not compromising regulation."[32]

In addition, the SEC, Congress, and the securities industry were increasingly worried about regulatory duplication. Because multiple SROs existed in the securities industry, firms were subject to different—and sometimes conflicting—rules and duplicative examinations and disciplinary proceedings.[33] Approximately 180 firms were members of—and were thus regulated by—both the NASD and the NYSE's regulatory arm.[34] The NASD and NYSE made efforts to coordinate their regulatory programs, but the industry still believed that "duplication and redundancy will continue to occur as long as two separate entities regulate the same conduct of the same firms."[35] The SEC, likewise, recognized that "the existence of multiple SROs can result in duplicative and conflicting SRO rules, rule interpretations, and inspection regimes . . . and redundant SRO regulatory staff and infrastructure across SROs."[36]

In light of the substantial changes in the securities markets and the concerns about regulatory redundancy, the SEC offered seven reform options that ranged from modifications of the existing system to replacement of the SRO system with direct regulation by the SEC.[37] One option was the so-called hybrid model, under which there would be a single-member SRO to which all broker-dealers would belong. That SRO would set membership requirements for firms and their registered representatives and write rules related to financial condition, margin,

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[31] NYSE, "Stock of New Public NYSE Group, Inc. Begins Trading," news release, March 8, 2006, http://www.nyse.com/press/1141729831759.html; NYSE, "NYSE/Archipelago Merger Gains Final SEC Approval," news release, March 8, 2006, http://www.nyse.com/press/1141083887100.html.
[32] SRO Hearing (statement of Robert R. G. Glauber, chairman and chief executive officer, NASD), 3.
[33] Securities Industry Association, "White Paper," 9–10.
[34] SRO Hearing (statement of Glauber), 89.
[35] SRO Hearing (statement of Marc E. Lackritz, president, Securities Industry Association), 111.
[36] SEC SRO Concept Release, 71264.
[37] Id. at 71275.

customer relationships, supervision, and sales practices.[38] Exchanges would continue to operate as SROs, but only with respect to regulation of their own markets.[39] Another option posited by the SEC would have given a single SRO authority over all markets and firms, but a concern with this approach was the "lack [of] market specific expertise."[40] The principal securities industry trade group explained that its preferred approach was the hybrid model because that model would eliminate redundancies and conflicts in member regulation while allowing for continued market-specific regulation:

> Enhanced regulatory efficiency will allow both the SROs and firms to use compliance resources more effectively. Regulatory accountability will be bolstered as a result of one entity being responsible for overseeing broker-dealer activity at the SRO level. Finally, the regulatory expertise of the SRO staff will expand as a single SRO gains the resources, power, and prestige to attract talented staff, and [*sic*] keeping the expertise close to the markets whose day-to-day activities it regulates. At the same time, the existence of multiple-market SROs, each with responsibility over those regulations applicable to its unique trading structures, will keep market expertise where it is most useful.[41]

A version of the hybrid model became a reality with the merger of the member regulation functions of the NASD and NYSE Regulation in 2007.[42] The result was FINRA—a more powerful successor to the NASD.[43] FINRA "would provide member firm regulation for securities firms that do business with the public in the United States."[44] Specifically, the new SRO was "responsible for rule writing, firm examination, enforcement and arbitration and mediation functions, along with all functions that were previously overseen solely by NASD, including

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[38] Id. at 71277.
[39] Id. at 71278.
[40] Id. at 71280.
[41] SRO Hearing (statement of Lackritz), 112.
[42] FINRA, "NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority," news release, July 30, 2007, http://www.finra.org/Newsroom/NewsReleases/2007/p036329.
[43] FINRA was created by amending the NASD's bylaws. SEC, Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change to Amend the By-Laws of NASD to Implement Governance and Related Changes to Accommodate the Consolidation of the Member Firm Regulatory Functions of NASD and NYSE Regulation, Inc., 72 Fed. Reg. 42169–90 (2007).
[44] Id. at 42170.

market regulation under contract for NASDAQ" and three other exchanges.[45] The SEC, in approving the consolidation, explained that it was "intended to help streamline the broker-dealer regulatory system, combine technologies, and permit the establishment of a single set of rules governing membership matters, with the aim of enhancing oversight of U.S. securities firms and assuring investor protection."[46] NYSE Regulation retained the responsibility for regulating its markets (as opposed to its member firms).

2. FINRA's Functions

Through the consolidation, FINRA solidified its role as a front-line regulatory force of almost equal weight with the SEC. At the end of 2012, FINRA regulated approximately 4,100 firms, 161,000 branch offices, and 636,000 registered securities representatives.[47] FINRA has approximately 3,400 employees and a budget of nearly $1 billion.[48] By comparison, the other major securities regulator—the SEC—has a staff of approximately 4,000 and a budget of approximately $1.3 billion.[49] Although not directly comparable given the different nature of the entities registered with the SEC, the SEC oversees more than 25,000 firms.[50]

> FINRA's stated substantive objectives are as follows:
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> (1) To promote through cooperative effort the investment banking and securities business, to standardize its principles and practices, to promote therein high standards of commercial honor, and to encourage and promote among members observance of federal and state securities laws;

[45] FINRA, "NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority."
[46] SEC, "SEC Gives Regulatory Approval for NASD and NYSE Consolidation," news release, July 26, 2007, http://www.sec.gov/news/press/2007/2007-151.htm.
[47] FINRA, *FINRA 2013 Year in Review and Annual Financial Report* (Washington, DC: FINRA, 2014), 8.
[48] Id., 8–9.
[49] SEC, *Fiscal Year 2013 Agency Financial Report* (Washington, DC: SEC, 2014), 10, 38.
[50] *Hearing on the SEC Budget before the Subcommittee on Financial Services and General Government, Committee on Appropriations of the United States House of Representatives*, 112th Cong. (2013) (statement of Mary Jo White, chair, SEC), http://www.sec.gov/News/Testimony/Detail/Testimony/1365171516034#_ftnref3.

> (2) To provide a medium through which its membership may be enabled to confer, consult, and cooperate with governmental and other agencies in the solution of problems affecting investors, the public, and the investment banking and securities business;
>
> (3) To adopt, administer, and enforce rules of fair practice and rules to prevent fraudulent and manipulative acts and practices, and in general to promote just and equitable principles of trade for the protection of investors; [and]
>
> (4) To promote self-discipline among members, and to investigate and adjust grievances between the public and members and between members.[51]

In carrying out these objectives, FINRA performs a wide range of functions. Broker-dealers doing business with the public and certain persons associated with them must register with FINRA. FINRA administers qualifying examinations for firms' principals and employees who perform securities functions (so-called registered representatives).[52] FINRA maintains a lengthy rulebook that governs the activities of member firms and their associated persons.[53] The rules cover all aspects of the securities business, including registration, continuing education, firm and member conduct, prohibitions against the use of fraudulent devices, "know your customer" and suitability requirements, "best execution" obligations for customer transactions, member firm supervisory responsibilities, communications with the public and with customers, financial condition, margin, operations, books and records, anti-money-laundering responsibilities, and transactions with customers.[54]

As a registered securities association, FINRA enforces its own rules and the federal securities laws.[55] In addition, FINRA enforces the rules of another SRO, the Municipal Securities Rulemaking Board, which writes rules for the municipal securities markets, but is not authorized

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[51] FINRA, "Restated Certificate of Incorporation of Financial Industry Regulatory Authority, Inc.," July 2, 2010, http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=4589.
[52] FINRA, "FINRA Registration and Examination Requirements," updated October 15, 2014, http://www.finra.org/industry/compliance/registration/qualificationsexams/qualifications/p011051.
[53] FINRA, "FINRA Rules," accessed April 14, 2014, http://www.finra.org/Industry/Regulation/FINRARules.
[54] FINRA, *FINRA Manual*, accessed December 3, 2014, http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1.
[55] 15 U.S.C. § 78o-3(b)(2) (2012).

to enforce these rules.[56] FINRA conducts routine examinations of member firms and branch offices and cause examinations that are motivated by a particular concern or tip. In 2012, for example, FINRA conducted more than 1,800 routine firm examinations, 800 branch office examinations, and 5,100 cause examinations.[57] FINRA also conducts multifirm sweep examinations, such as a targeted examination of high-frequency trading in July 2013 and a cybersecurity examination in January 2014.[58]

When FINRA finds violations of its rules, of the rules of the Municipal Securities Rulemaking Board, or of federal securities laws, it is authorized to bring disciplinary actions. FINRA's sanctions include censures, fines, restitution to harmed investors, suspensions, and permanent bars from the industry.[59] In 2013, FINRA brought 1,535 disciplinary actions.[60] Most disciplinary actions are settled.[61] Contested actions are heard by a panel composed of a professional hearing officer and two industry representatives.[62] FINRA's National Adjudicatory Council, a 14-member panel with equal numbers of public and industry members, hears appeals from hearing panel decisions.[63] FINRA's board of governors can choose to review the council's decision. As discussed in the next section, FINRA's disciplinary decisions are subject to SEC review. FINRA actively refers potential civil and criminal cases to governmental regulators.[64]

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[56] MSRB, "Market Regulation," accessed April 15, 2014, http://www.msrb.org/About-MSRB/Programs/Market-Regulation.aspx.
[57] FINRA, *FINRA 2012 Year in Review and Annual Financial Report* (Washington, DC: FINRA, 2013), 8.
[58] FINRA publishes summaries of the information requested in its sweep examinations in targeted examination letters. The letters for these two examinations and others are available on FINRA's website, accessed April 15, 2014, at http://www.finra.org/Industry/Regulation/Guidance/TargetedExaminationLetters.
[59] FINRA, *Sanction Guidelines* (Washington, DC: FINRA, 2013), 9–11.
[60] FINRA, "About FINRA," accessed April 15, 2014, http://www.finra.org/AboutFINRA.
[61] Black, "Punishing Bad Brokers," 47.
[62] FINRA, "Adjudication," accessed March 25, 2014, http://www.finra.org/Industry/Enforcement/Adjudication.
[63] FINRA, "National Adjudicatory Council," accessed March 25, 2014, http://www.finra.org/Industry/Enforcement/Adjudication/NAC/naccommittee.
[64] FINRA made approximately 700 such referrals in 2012. See FINRA, *FINRA 2012 Year in Review*, 3.

FINRA also performs a number of services ancillary to its primary tasks of registering, inspecting, and disciplining members. It administers the arbitration process through which firms and their investors and employees are required to resolve business disputes.[65] FINRA also administers a voluntary mediation program.[66] FINRA makes certain information it collects from broker-dealers and associated persons available to investors through BrokerCheck, a public online database for investors.[67] BrokerCheck also includes information about investment advisers and their associated persons. On behalf of the SEC and the state securities administrators, FINRA developed and runs the Investment Adviser Registration Depository, an online registration and filing system for investment advisers.[68] FINRA is bidding for the contract to implement a consolidated audit trail system that will track equity and option orders and executions and that is currently being designed by a consortium of SROs.[69] FINRA's Trade Reporting and Compliance Engine, known as TRACE, collects and publicly disseminates data about OTC corporate bond transactions.[70] FINRA's subsidiary, the FINRA Investor Education Foundation, works on financial education initiatives.

FINRA is a not-for-profit organization that is incorporated in Delaware. It funds itself with a mix of fees and fines. Table 1 sets forth the sources of FINRA's revenue for fiscal years 2012 and 2013.

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[65] FINRA, "Arbitration Overview," accessed April 15, 2014, http://www.finra.org/ArbitrationAndMediation/Arbitration/Overview.
[66] FINRA, "Mediation Overview," accessed April 15, 2014, http://www.finra.org/ArbitrationAndMediation/Mediation/Overview.
[67] BrokerCheck is available on FINRA's website, accessed March 25, 2014, at http://www.finra.org/Investors/ToolsCalculators/BrokerCheck.
[68] FINRA, "What Is IARD?," accessed March 25, 2014, http://www.iard.com/WhatIsIARD.asp.
[69] SEC, "SEC Rule 613 Consolidated Audit Trail RFP Bid Submissions," last modified April 2, 2014, http://catnmsplan.com/process/P469129.
[70] "Trade Reporting and Compliance Engine (TRACE)," accessed March 25, 2014, http://www.finra.org/Industry/Compliance/MarketTransparency/TRACE.

Table 1. FINRA Revenues, Years Ended December 31, 2012, and December 31, 2013

Source	2012 revenues ($ millions)	2013 revenues ($ millions)
Regulatory fees: These fees include the trading activity fee, which firms pay on the sell side of every transaction in a covered security, and other assessments on firms, their branch offices, and their associated persons.	406.9	414.6
User fees: These fees include registration, examination, and continuing education fees and fees for reviewing firms' advertising and proposed public offerings.	164.9	206.4
Contract services fees: These payments include fees for surveillance and examination services that FINRA provides to NASDAQ, the NYSE, and the Trade Reporting Facilities, as well as fees connected with a FINRA-developed mortgage licensing system.	128.2	115.2
Transparency services fees: These payments include fees for TRACE and for other reporting facilities.	56.9	58.4
Dispute resolution fees: These fees are for arbitrations and mediations.	41.7	36.2
Other: FINRA's annual report does not specify what this category includes.	10.9	9.6
Fines: These payments are sanctions for rule violations. Fines are not used for operating expenses but for "capital expenditures and regulatory projects."	69.1	60.4

Source: FINRA, *FINRA 2012 Year in Review and Annual Financial Report* (Washington, DC: FINRA, 2013), 29, 40; FINRA, *FINRA 2013 Year in Review and Annual Financial Report* (Washington, DC: FINRA, 2014), 13.

Note: The table omits activity assessment fees, which FINRA pays to the SEC and then recoups from the industry.

In addition to its revenues, FINRA maintains a large investment portfolio—$1.6 billion at the end of 2012 and $1.7 billion at the end of 2013—"to support FINRA in fulfilling its mission of protecting investors and maintaining market integrity by providing FINRA with supplemental financial resources."[71] Investment returns have been an important source of income for FINRA

[71] FINRA, *FINRA 2012 Year in Review*, 19–20.

but have also been a source of losses.[72] FINRA adopted a lower-risk investment strategy after the investment portfolio incurred large losses in 2008.[73]

3. FINRA's Accountability Structure

Avoiding the label SRO, FINRA refers to itself as "the largest independent regulator of securities firms doing business with the public in the United States."[74] The use of the term *independent* in this context appears intended to signal FINRA's independence from both the securities industry and the government. The member firms over which "FINRA exerts meaningful control . . . given the statutory requirement for membership" have only a limited ability to influence FINRA.[75] Although the SEC oversees FINRA, its ability to influence FINRA is also limited.

FINRA is independent from industry because a board of governors, the majority of whom are not representatives of industry, runs FINRA. The FINRA board comprises 24 governors, including FINRA's chief executive officer; 13 public governors; and 10 industry representatives.[76] FINRA bylaws require the public governors to outnumber the industry governors.[77] Public governors cannot have any "material business relationship" with a broker, a dealer, or another SRO.[78] To reflect the different types of firms affected by FINRA regulation, the industry governors must include a floor member governor, an independent dealer or

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[72] Dan Jamieson, "FINRA Turns a Profit, Helped by Investments, Fee Increases," *Investment News*, June 28, 2013, http://www.investmentnews.com/article/20130628/FREE/130629921/finra-turns-a-profit-helped-by-investments-fee-increases.
[73] FINRA, *2008 Year in Review and Annual Financial Report: Reforming Regulation to Better Protect Investors* (Washington, DC: FINRA, 2009), 29.
[74] FINRA, *FINRA 2012 Year in Review*, 8.
[75] Michael Deshmukh, "Is FINRA a State Actor? A Question That Exposes the Flaws of the State Action Doctrine and Suggests a Way to Redeem It," *Vanderbilt Law Review* 67, no. 4 (2014): 1209.
[76] FINRA, "Corrected: FINRA Announces New Public Board Members," news release, November 18, 2014, https://www.finra.org/Newsroom/NewsReleases/2014/P601699. Members of the board are listed on FINRA's website, accessed December 8, 2014, at http://www.finra.org/AboutFINRA/Leadership/P009756.
[77] FINRA, *By-Laws of the Corporation*, article VII, § 4(a).
[78] Id., article I, paragraph (tt).

insurance affiliate governor, an investment company affiliate governor, three governors from small firms, one governor from a midsize firm, and three large firm governors.[79] Industry members cannot outnumber public members of the nominating committee—which has primary authority to nominate replacement governors.[80] Small, medium, and large firms can petition to place a candidate on the ballot who has not been nominated by the nominating committee.[81] The board structure, which is intentionally weighted away from the industry, is not consistent with self-regulation. An organization run by a board that is dominated by people who are not in the industry is not an SRO; it is a regulator with industry representation. The independence from industry extends beyond the board. Onnig H. Dombalagian, professor of law at Tulane University Law School, has documented the trend away from an SRO staff with deep industry expertise and its replacement with a bureaucratized staff.[82]

FINRA's primary outside accountability comes through SEC oversight. As explained in the first section of this paper, the SEC's role in monitoring and guiding SROs has increased over time, and now the agency has broad powers to influence FINRA's activities, including its rulemaking and disciplinary actions. FINRA is subject to SEC reporting requirements.[83] The SEC conducts routine and for-cause inspections of FINRA. FINRA files proposed rule changes with the SEC before the changes take effect so the SEC can publish those changes in the *Federal Register* for public comment and decide whether to approve or disapprove them.[84] The SEC can abrogate, add to, or delete FINRA rules through notice-and-comment rulemaking.[85] The SEC

[79] Id., article VII, § 4(a).
[80] Id., article VII, § 9(b).
[81] Id., article VII, § 10.
[82] Onnig H. Dombalagian, "Self and Self-Regulation: Resolving the SRO Identity Crisis," *Brooklyn Journal of Corporate Finance and Commercial Law* 1, no. 2 (2007): 329–30.
[83] See, for example, 17 C.F.R. § 240.15Aj-1.
[84] 15 U.S.C. §§ 78s(b)(1) and (b)(2).
[85] Id., § 78s(c).

also has authority—of its own volition or through an appeal by the disciplined party—to review disciplinary actions once FINRA has had its last word.[86] The SEC can affirm, remand, or revise FINRA's sanction.[87] As the SEC's enforcement action against the NASD in 1996 illustrates, the SEC can force structural and governance changes through enforcement proceedings.

In practice, however, FINRA operates with substantial independence from the SEC. FINRA can set its own rulemaking and disciplinary agendas and budget without SEC input. The Government Accountability Office found that "SEC's oversight of FINRA's programs and operations varied, with some programs and operations receiving regular oversight and others receiving limited or no oversight."[88] Among the areas over which the Government Accountability Office found that the "SEC has conducted limited or no oversight" is executive compensation, despite the comparatively high FINRA executive compensation packages.[89] Although the SEC has the power to approve or disapprove FINRA rules, the SEC's Division of Trading and Markets typically exercises this authority through a delegation from the commission.[90] To rescind the delegation, two commissioners must object in writing within five days of being notified of staff plans to disapprove a rule.[91] As a consequence, FINRA rules do not typically attract close attention from the SEC's commissioners. Because many FINRA disciplinary actions are settled, the SEC reviews only a small subset of disciplinary actions.

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[86] FINRA, "Adjudication," accessed March 25, 2014, http://www.finra.org/Industry/Enforcement/Adjudication; 15 U.S.C. § 78s(d) (2012).
[87] 15 U.S.C. § 78s(e).
[88] Government Accountability Office, *Securities Regulation: Opportunities Exist to Improve SEC's Oversight of the Financial Industry Regulatory Authority* (2012), 7.
[89] FINRA's chief executive officer earns approximately $2.25 million a year. FINRA, *FINRA 2012 Year in Review*, 23. This amount is more than the SEC chairman's salary of $165,300 and, according to a recent analysis, more than heads of securities industry SROs and securities industry trade groups. Lynne Hume, "SEC Chair's Salary Far below Group Execs Representing Firms, Individuals Overseen," *Bond Buyer*, September 3, 2013, http://www.bondbuyer.com/issues/122_170/sec-chairs-salary-far-below-firm-executives-overseen-regulated-1055210-1.html.
[90] 17 C.F.R. § 230.30-3(a)(12).
[91] Id.

The SEC's ultimate power over FINRA comes from the SEC's ability to revoke the SRO's registration as a securities association under the Exchange Act, but the drastic nature of this remedy makes the exercise of this power unlikely.[92] There would be no nongovernmental organization in place to take FINRA's place as the statutorily requisite SRO. FINRA, therefore, has substantial leverage in its relationship with the SEC.

FINRA is subject to less SEC oversight than the Public Company Accounting Oversight Board (PCAOB), the nonprofit, quasi-governmental regulator responsible for overseeing auditors of public companies and broker-dealers. The SEC, for example, approves the PCAOB budget and appoints the PCAOB's members. One commentator argues that, if the Supreme Court applied the same reasoning it used in its consideration of the PCAOB's constitutionality,[93] it would find FINRA to be unconstitutional because of the SEC's inability to remove FINRA's board members.[94] At a minimum, this inability limits FINRA's accountability to the SEC.

4. FINRA'S Comparative Lack of Accountability

FINRA's regulatory powers are similar to those of the SEC, but its accountability structure is very different. Operating on the strength of a government mandate and carrying out a regulatory mission using government-like tools, FINRA is difficult to distinguish from its patron agency. As does the SEC, FINRA enjoys immunity from suit in carrying out its regulatory responsibilities.[95] As Black documents, "FINRA (including its predecessor, the NASD) has

[92] Marianne K. Smythe, "Government Supervised Self-Regulation in the Securities Industry and the Antitrust Laws: Suggestions for an Accommodation," *North Carolina Law Review* 62 (1984): 483.
[93] Free Enterprise Fund v. Public Company Accounting Oversight Board, 130 S. Ct. 3138 (2010).
[94] Joseph McLaughlin, "Is FINRA Constitutional?," *Engage* 12, no. 2 (2011): 113–14.
[95] See, for example, Standard Inv. Chartered, Inc. v. Nat'l Ass'n of Sec. Dealers, 637 F.3d 112, 114–15 (2d Cir. 2011), *cert. denied*, 132 S. Ct. 1093 (2012). For a discussion of immunity as it has been applied in the SRO context, see Rohit A. Nafday, "From Sense to Nonsense and Back Again: SRO Immunity, Doctrinal Bait-and-Switch, and a Call for Coherence," *University of Chicago Law Review* 77, no. 2 (2010): 847–85.

evolved from a membership association primarily responsible for enforcing industry norms to a regulator that enforces federal securities laws as an adjunct of the SEC."[96] William A. Birdthistle, professor of law at Illinois Institute of Technology Chicago-Kent College of Law, and M. Todd Henderson, professor of law at the University of Chicago Law School, put the matter even more starkly when they observe that "financial SROs are transforming into a 'fifth branch' of government."[97] Dombalagian worries that SROs "are likely to behave as if they are an extension of the Commission's own compliance and enforcement arms, with the added benefit that they are subsidized directly by industry fees and not constrained by the same statutory limitations on their power."[98]

FINRA is not subject to mechanisms comparable to those that hold government regulators accountable to Congress, the president, and the public.[99] In FINRA's case, a rigorous administrative process is also important for ensuring accountability to investors[100] and to FINRA's own members.[101] Agencies have politically accountable heads. The SEC, for example, is governed by a five-member, politically balanced commission. The Freedom of Information Act enables the public to obtain documents from government agencies.[102] Most federal agencies are subject to congressional appropriations, which enables Congress to exercise some control over them. The SEC is no exception. Although the SEC receives fees on securities transactions to cover its costs, Congress determines how much the SEC may spend. The penalties and

[96] Black, "Punishing Bad Brokers," 29.
[97] William A. Birdthistle and M. Todd Henderson, "Becoming a Fifth Branch," *Cornell Law Review* 99, no. 1 (2013): 5.
[98] Dombalagian, "Self and Self-Regulation," 330.
[99] Birdthistle and Henderson, "Becoming a Fifth Branch," 6.
[100] Steven Irwin, Scott Lane, Carolyn Mendelson, and Tara Tighe, "Self-Regulation of the American Retail Securities Markets: An Oxymoron for What Is Best for Investors?," *University of Pennsylvania Law Review* 14 (2012): 1071.
[101] Roberta S. Karmel, "Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies," *Stanford Journal of Law, Business, and Finance* 14 (2008): 197.
[102] 5 U.S.C. § 552.

disgorgement collected by the SEC are used to compensate victims or are paid to the US Department of the Treasury; they are not used to supplement the SEC's budget.[103] Regulatory agencies conduct their rulemaking under the constraints of the Administrative Procedure Act, which requires agencies to take into account public comments on proposed rules.[104] Regulated entities and individuals can challenge the process by which a regulation was made. Multimember regulatory agencies generally have to conduct their rulemaking meetings in public.[105] As part of the rulemaking process, agencies use economic analysis to understand the problem they are trying to solve, to identify potential alternative solutions, and to assess the costs and benefits of those solutions. In fact, the Exchange Act explicitly requires that

> whenever pursuant to this title the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.[106]

Courts have interpreted that provision to require the SEC to perform economic analysis in its rulemakings.[107]

The Exchange Act economic analysis requirement on its face applies to SRO rulemakings, but, to date, the SEC has generally not raised the issue. An exception occurred recently when SEC commissioners Daniel M. Gallagher and Troy A. Paredes took the unusual step of dissenting from the approval of another SRO's rule because it lacked rigorous analysis:

> If there is any question as to the rigor of an SRO's analysis, then it is all the more paramount that the Commission not defer to the SRO's claims, conclusions, and judgments. The Commission has a fundamental oversight role with respect to SROs, and

[103] FINRA, as noted in table 1, uses fines to cover capital expenditures. This practice gives the regulator an incentive to impose fines and thus potentially clouds its disciplinary discretion.
[104] 5 U.S.C. §§ 551–59.
[105] Id. at § 552b.
[106] 15 U.S.C. § 78c(f).
[107] See, for example, Business Roundtable v. SEC, 647 F.3d 1144, 1148 (D.C. Cir. 2011).

> undue deference to an SRO in the SRO rulemaking process undercuts the basic structure of that regulatory relationship.[108]

FINRA recently hired a chief economist and pledged to integrate his work into the rulemaking process.[109] It remains to be seen how influential the economist's role will be within FINRA.

As a nongovernmental regulator, FINRA faces some constraints in its disciplinary program that governmental regulators do not. Whereas a firm or individual can appeal an SEC decision with respect to a FINRA disciplinary action to a federal appellate court,[110] FINRA cannot. Nor can FINRA sue to collect its fines.[111] Because FINRA membership is mandatory for brokers doing business with the public, however, FINRA has significant leverage—the ability to bar and suspend—to force the payment of monetary sanctions.[112] The prospect of an industry bar also gives FINRA leverage to force individuals to answer questions during FINRA proceedings. Individual members generally are unable to assert their Fifth Amendment rights not to incriminate themselves in a FINRA proceeding; they have to answer FINRA's questions or face getting kicked out of the industry.[113] An exception may be made in cases in which FINRA's proceeding is being carried on as part of a joint proceeding with a government agency.[114] Under the prevailing case law, it is unclear what it would take to make FINRA a state actor subject to

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[108] Daniel M. Gallagher and Troy A. Paredes, "Statement Regarding Commission Approval of MSRB Rule G-17 Interpretive Notice," SEC, Washington, DC, May 14, 2012, http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1365171490456#.VH-eX4ekawk.

[109] FINRA, "Jonathan S. Sokobin Named FINRA's Chief Economist," news release, April 30, 2013, https://www.finra.org/Newsroom/NewsReleases/2013/P251015; Dave Michaels, "FINRA Hires First Chief Economist to Boost Cost-Benefit Analysis," *Bloomberg*, April 30, 2013, http://www.bloomberg.com/news/2013-04-30/finra-hires-first-chief-economist-to-boost-cost-benefit-analysis.html.

[110] 15 U.S.C. § 78y(a)(1) (2012).

[111] "Congress did not intend to empower FINRA to bring court proceedings to enforce its fines." Fiero v. FINRA, 660 F.3d 569, 577 (2d Cir. 2011).

[112] For a discussion of the degree to which FINRA exercises leverage, see Jonathan Macey and Caroline Novogrod, "Enforcing Self-Regulatory Organizations' Penalties and the Nature of Self-Regulation," *Hofstra Law Review* 40, no. 4 (2012): 963–1003.

[113] United States v. Solomon, 509 F.2d 863, 872 (2d Cir. 1975).

[114] See, for example, In the Matter of Justin F. Ficken, Exchange Act Release 54,699 (November 3, 2006), 11 ("we consider the burden of demonstrating joint activities sufficient to render NASD a state actor to be high, and that burden falls on the party asserting state action").

constitutional claims.[115] State securities regulators contend that FINRA has withheld information from them to avoid being classified as a state actor.[116] By avoiding the state actor classification, FINRA has thus far managed to exercise governmental powers without governmental accountability.

5. FINRA's Regulatory Aspirations

Amid rising concerns about its lack of accountability, FINRA has actively sought opportunities to expand its regulatory authority. Most notably, in the wake of the crisis, FINRA argued that it should become the SRO for investment advisers.[117] FINRA also has gradually expanded its role as a regulator of securities markets. In addition, through the JOBS (Jumpstart Our Business Startups) Act, Congress recently gave FINRA responsibility for registering and overseeing crowdfunding portals, the intermediaries through which companies will be able to raise small amounts of equity funding.[118] As FINRA expands its regulatory reach beyond broker-dealer oversight, it will look even less like an SRO and more like a governmental regulator.

State securities regulators and the SEC currently share regulatory responsibility for US investment advisers. Reflecting a concern that the SEC was not examining investment advisers frequently enough, the Dodd-Frank Act of 2010 adjusted the division of labor by shifting additional small investment advisers from SEC to state oversight.[119] Despite this temporary

[115] For a discussion of this issue and a suggested framework for deciding whether FINRA is a state actor, see Deshmukh, "Is FINRA a State Actor?," 1173.
[116] Irwin et al., "Self-Regulation of the American Retail Securities Markets," 1068.
[117] Richard Ketchum, chairman and CEO, FINRA, "Testimony before the Subcommittee on Capital Markets and Government Sponsored Enterprises of the U.S. House of Representatives," September 13, 2011, accessed April 15, 2014, http://www.finra.org/Newsroom/Speeches/Ketchum/P124416.
[118] Jumpstart Our Business Startups Act, Pub. L. No. 112-106 § 304(a) (2012); FINRA, "Jumpstart Our Business Startups (JOBS) Act: FINRA Requests Comment on Proposed Funding Portal Rules and Related Forms," Regulatory Notice 13-34 (October 2013).
[119] Dodd-Frank Wall Street Reform and Consumer Protection Act § 410 (amending 15 U.S.C. § 80b-3a(a)).

reprieve, SEC staff members anticipate that as the number of advisers rises, the number of examinations will once again overwhelm the SEC's resources.[120] The SEC staff suggested creating an SRO for investment advisers or allowing FINRA to examine its registrants under the Investment Advisers Act.[121]

FINRA has expressed a willingness to become the SRO for investment advisers. Particularly because many investment adviser representatives are also registered representatives under FINRA's jurisdiction, FINRA maintains that it is prepared to take over responsibility for investment advisers.[122] FINRA argues that "given our experience operating a nationwide program for examinations and our ability to leverage existing technology and staff resources to support a similar program for investment advisers, we believe we are uniquely positioned to serve as at least part of the solution to this pressing problem" of inadequate investment adviser oversight.[123] FINRA cites its own failure to detect the Madoff fraud in support of its call to become the SRO for investment advisers. The special review committee that FINRA set up to investigate its failures in connection with the Madoff and Stanford frauds[124] recommended that FINRA "proactively seek new jurisdiction from Congress to regulate activities under the Investment Advisers Act to give it more effective means to detect future Madoff-like situations."[125] FINRA's use of the Madoff fraud as a justification for additional regulatory authority over investment

[120] Division of Investment Management, SEC, "Study on Enhancing Investment Adviser Examinations," SEC, Washington, DC, January 2011, 38.
[121] Id. at 39.
[122] Ben Protess, "A Regulator Moves to Expand Power over Wall St.," *New York Times*, April 25, 2011, http://dealbook.nytimes.com/2011/04/25/postcrisis-a-regulator-moves-to-expand-power-over-wall-st/?_r=0.
[123] *H.R. 4624, the Investment Adviser Oversight Act of 2012: Hearing before the Committee on Financial Services*, 112th Cong. 13–15 (2012) (statement of Richard G. Ketchum, chief executive officer, FINRA), http://www.finra.org/Newsroom/Speeches/Ketchum/P126815.
[124] Stanford, a FINRA member firm, perpetrated a $7.2 billion fraud by selling foreign certificates of deposit. Charles A. Bowsher, Ellyn L. Brown, Harvey J. Goldschmid, and Joel Seligman, "Report of the 2009 Special Review Committee on FINRA's Examination Program in Light of the Stanford and Madoff Schemes," FINRA, Washington, DC, 2009, 2–4.
[125] Id. at 6.

advisers is puzzling because during most of the time in which the fraud occurred, the firm was registered only as a broker-dealer and not as an investment adviser. Consequently, as John C. Coffee, professor of law at Columbia Law School, notes, FINRA arguably bears responsibility for not detecting the fraud.[126]

If FINRA succeeds in becoming the SRO for investment advisers, its status as an SRO will be further compromised as it tries to balance the needs of a new set of members. FINRA's rules-based regulatory regime is very different from the current investment adviser regime, which is based on the less precise, but some argue more demanding, fiduciary duty standard. FINRA reportedly has been softening that distinction by "stressing to brokerage firms to act in the best interests of their clients."[127] If FINRA were to become the SRO for investment advisers, it might seek to craft a single regulatory approach for broker-dealers and investment advisers. Combining two industry groups—albeit ones with overlapping functions—into a single SRO would lessen one of the advantages of self-regulation: the ability to apply the expertise from within the industry to design appropriate regulations for the industry. Given the tensions between the two groups, a joint SRO could also undermine the industry's trust in the regulator, another advantage of self-regulation.

FINRA also has sought actively to add more market venues to its regulatory portfolio. Exchanges contract with FINRA to perform market regulation. Recently, with the addition of Better Alternative Trading System (BATS) Global Markets, FINRA will be responsible for

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[126] *Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform: Hearing before the US Senate Committee on Banking, Housing, and Urban Affairs*, 111th Cong. (2011) (statement of John C. Coffee Jr., professor of law, Columbia University School of Law), 13, http://banking.senate.gov/public/index.cfm ?FuseAction=Files.View&FileStore_id=d3f6706f-2d65-4fad-a349-d839e04149e9.

[127] Mark Schoeff Jr., "Is FINRA Pulling Its Efforts to Be the SRO for Advisers?," *Investment News*, April 13, 2014, http://www.investmentnews.com/article/20140413/REG/304139997/is-finra-pulling-its-effortsto-be-the -sro-for-advisers.

monitoring 99 percent of the market of US-listed equities.[128] In the first few years after 2000, when different regulatory models were being considered, one of the justifications for the hybrid model was its ability to bifurcate member and market regulation to "get centralized expertise . . . for operations that are similar across the board at the member level [and] leave market-based surveillance [and] market-based expertise in the marketplaces."[129] With the concentration of market and member regulation in FINRA, that distinction has been lost.

Even within its core jurisdiction of member regulation, FINRA is asserting itself more aggressively. In December 2013, it sought comment on a plan to require firms to provide specific retail customer information, such as account types and categories, investment profiles, dates of birth, details of account activities and balances, and descriptions of securities.[130] Subsequently, FINRA retreated and promised not to "require the submission of information that would identify to FINRA the individual account owner, particularly, account name, account address, or tax identification number."[131] Nevertheless, FINRA's plan for such extensive data collection about individual accounts suggests a far-reaching regulatory vision.

Conclusion

FINRA has become a very powerful force in the securities markets. As its choice to characterize itself as an "independent regulator" reflects, FINRA is not a self-regulator. Its members are not regulating themselves; they are being regulated by FINRA, just as they are regulated by the SEC. FINRA's status as a nongovernmental regulator, however, enables it to avoid the scrutiny

[128] FINRA, "BATS Global Markets, FINRA Enter Regulatory Service Agreement," news release, February 6, 2014, http://www.finra.org/Newsroom/NewsReleases/2014/P443474.
[129] SRO Hearing (statement of Lackritz), 32.
[130] FINRA, "Regulatory Notice 13-42: Comprehensive Automated Risk Data System," December 2013, http://www.finra.org/Industry/Regulation/Notices/2013/P412658.
[131] FINRA, "Update Regarding Regulatory Notice 13-42—Comprehensive Automated Risk Data System," March 4, 2014, http://www.finra.org/Industry/Regulation/Notices/2013/P451243.

and procedural requirements to which a government agency performing the same tasks would be subject. Before FINRA succeeds in further expanding its regulatory footprint by taking on additional responsibilities, policymakers should revisit the long-debated questions about whether self-regulation works in its current manifestation and, if not, what should be done about it. One option would be to acknowledge that FINRA looks a lot like the SEC and accordingly fold FINRA into the SEC.[132] Alternatively, FINRA could be remade into an organization that is run by the industry it regulates. In other words, FINRA could become a true self-regulator. Competing SROs might emerge to tailor regulation to a particular group of firms, such as smaller broker-dealers. Another option would be to enhance FINRA's public disclosure and procedural obligations. Procedural requirements should include a clear requirement to conduct and document economic analysis and greater procedural protections in connection with disciplinary actions.

The shift from self-regulation to independent regulation has been gradual and has been driven in part by legitimate concerns about conflicts of interest. As academics continue to point out, however, SROs offer real advantages over governmental regulators. Birdthistle and Henderson lay out a number of those benefits: SROs have expertise, enjoy the trust of their regulated entities, are efficient, are better able to tailor rules, and are well suited to handle minor missteps.[133] Moreover, a long history of self-regulation in the securities markets and practical considerations—the money and staff that the SEC would need to take over FINRA's work[134]—

[132] See, for example, the letter from Danielle Brian and Michael Smallberg, Project on Government Oversight, to US House of Representatives and Senate Committees, February 23, 2010, http://www.pogo.org/our-work/letters/2010/er-fra-20100223-2.html.
[133] Birdthistle and Henderson, "Becoming a Fifth Branch," 55–58.
[134] This argument in favor of self-regulation is a common one. But see Smythe, "Government Supervised Self-Regulation," 477n10, who states, "Of course, the cost of self-regulation ultimately is passed through to brokerage firm customers in the form of higher fees, so a lessened burden on the taxpayer is accomplished at the expense of securities industry customers."

lead many to believe that "self-regulation of the broker-dealer industry is here to stay."[135] After decades of modifications, FINRA's version of self-regulation embodies a troubling independence from government, industry, and the public. Future modifications should be aimed at restoring accountability to this powerful regulator.

[135] Black, "Punishing Bad Brokers," 27.