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## ENFORCING SELF-REGULATORY ORGANIZATION'S PENALTIES AND THE NATURE OF SELF-REGULATION

*Jonathan Macey & Caroline Novogrod\**

### I. INTRODUCTION

Few issues are as poorly understood and under-theorized as the concept of “industry self-regulation.” The Second Circuit recently raised important issues about the nature of such self-regulations when it held that the industry’s self-regulatory agency, the Financial Industry Regulatory Authority (“FINRA”),<sup>1</sup> lacked the authority to judicially enforce the fines it levies against member broker-dealers.<sup>2</sup>

In this Article we provide a theoretical framework for understanding the nature of self-regulation and then discuss the role of courts in effectuating the self-regulatory process. Our thesis is simple: the success of industry self-regulation critically depends on the market power of the firms in the self-regulatory organization (“SRO”). If the firms have market power, then as long as the industry generates profits for members, self-regulation can work. But if either profitability or market power decline, self-regulation will fail. We believe that our analysis leads to a deeper understanding of the appropriate relationship

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1. With approximately 3300 employees and twenty regional offices in addition to principal offices in New York City and Washington, D.C., FINRA is “the largest independent regulator for all securities firms doing business in the United States. FINRA’s mission is to protect America’s investors by making sure the securities industry operates fairly and honestly. All told, FINRA oversees about 4380 brokerage firms, about 163,150 branch offices and approximately 633,000 registered securities representatives.” Fin. Indus. Reg. Auth., *About the Financial Industry Regulatory Authority*, FINRA, <http://www.finra.org/AboutFINRA/index.htm> (last visited Nov. 5, 2012) [hereinafter *About FINRA*].

2. *Fiero v. Fin. Indus. Reg. Auth., Inc.*, 660 F.3d 569, 571-72, 574 (2d Cir. 2011).

between self-regulatory agencies and the judiciary, where the issue is whether and to what extent a self-regulatory organization can invoke the power of the courts to enforce its rules and disciplinary decisions.

FINRA was created pursuant to the Securities Exchange Act of 1934 (the "Exchange Act"),<sup>3</sup> which contemplated a system wherein member-owned securities exchanges and broker-dealer associations would regulate the activities of its member securities firms, subject to the oversight of the Securities and Exchange Commission ("SEC").<sup>4</sup> The securities self-regulatory framework under which FINRA operates has undergone significant changes since its creation. One such change occurred in 2007, when FINRA's predecessor, the National Association of Securities Dealers ("NASD"), and the regulatory arm of the New York Stock Exchange, Inc. ("NYSE"), merged to form FINRA, the single self-regulator for all securities firms doing business with the public.<sup>5</sup> Today, FINRA continues to provide regulation for all U.S. securities firms that transact with the public.<sup>6</sup> FINRA is responsible for the "surveillance, investigation and enforcement of more than eighty percent of U.S. equity trading."<sup>7</sup> The major securities exchanges now outsource significant oversight and disciplinary responsibilities, including market regulation functions, to FINRA.<sup>8</sup> The SEC has delegated significant duties to FINRA, which now monitors the internal operations of its members, all of which are also regulated by the SEC.<sup>9</sup> FINRA's revenue almost equals the operating budget of the SEC.<sup>10</sup>

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3. 15 U.S.C. § 78(a) *et seq.* (2006 & Supp. IV 2011).

4. *See generally id.*

5. 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., Exchange Act Release No. 34-56,145 (July 26, 2007), 72 Fed. Reg. 42,169, 42,169-70 (Aug. 1, 2007).

6. FIN. INDUS. REG. AUTH., GET TO KNOW US. 2-3 (2012), [hereinafter FINRA BROCHURE], available at <http://www.finra.org/web/groups/corporate/@corp/@about/documents/corporate/p118667.pdf>.

7. FIN. INDUS. REG. AUTH., FINRA 2010 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT 3 (2011) [hereinafter FINRA 2010 REPORT], available at <http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p127312.pdf>.

8. *See id.* at 7, 22; *see also About FINRA*, *supra* note 1; FINRA BROCHURE, *supra* note 6, at 2-3.

9. *See* FIN. INDUS. REG. AUTH., FINRA 2011 YEAR IN REVIEW AND ANNUAL FINANCIAL REPORT 1-3 (2012) [hereinafter FINRA 2011 REPORT], available at <http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p127312.pdf>; SEC. & EXCH. COMM'N, FY 2011 PERFORMANCE AND ACCOUNTABILITY REPORT 20-21, 129, (2011), [hereinafter SEC 2011 REPORT], available at <http://www.sec.gov/about/secpar/secpar2011.pdf>.

10. Compare FINRA 2011 REPORT, *supra* note 9, at 35, with SEC 2011 REPORT, *supra* note 9, at 35.

It is intriguing that an organization as wealthy and important as FINRA has difficulty enforcing its own rules.<sup>11</sup> We believe that this important fact has broad implications for our understanding of FINRA's responsibilities, as FINRA was unable to compel a former member to pay its fines. In *Fiero v. Financial Industry Regulatory Authority, Inc.*,<sup>12</sup> FINRA sought to collect a one million dollar fine it previously had assessed against a broker-dealer firm that FINRA also expelled for alleged improper short-selling activity.<sup>13</sup>

The Exchange Act obligates the securities association to "appropriately discipline[]" its members for violating the Exchange Act, SEC rules, and FINRA's own rules.<sup>14</sup> Permissible penalties include "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."<sup>15</sup>

FINRA does not have explicit statutory authorization to bring private rights of action in court to enforce the penalties it assesses against members.<sup>16</sup> The Second Circuit construed this to mean that Congress did not intend to grant such authority to SROs.<sup>17</sup> The court addressed the seemingly obvious gap in FINRA's enforcement scheme, which empowers FINRA to impose but not enforce fines, explaining, "FINRA fines are already enforced by a draconian sanction not involving court action."<sup>18</sup> According to the court, Congress knew that FINRA had always relied on this enforcement mechanism of expulsion and exclusion, and has therefore left the enforcement scheme unaltered.<sup>19</sup> It is precisely this claim about SROs in general and FINRA in particular that we analyze in this paper.

In our view, the mechanisms available to FINRA to enforce its rules and mandates reveal something profound about the nature of self-regulation in general, and specifically about the allocation of power between FINRA and the firms it regulates. The notion embraced by the Second Circuit, and perhaps by Congress as well, is that SROs such as

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11. See, e.g., *Fiero v. Fin. Indus. Reg. Auth., Inc.*, 660 F.3d 569, 571, 574 (2d Cir. 2011).

12. 660 F.3d 569.

13. *Id.* at 572; *Fiero v. Fin. Indus. Reg. Auth., Inc.*, 606 F. Supp. 2d 500, 506 (S.D.N.Y. 2009), *rev'd by*, 660 F.3d 569 (2d Cir. 2011).

14. Securities Exchange Act of 1934, 15 U.S.C. § 78o-3(b)(7) (2006). "The Exchange Act currently exposes SROs to disciplinary sanction if they fail to enforce the rules they promulgate." Onnig H. Dombalagian, *Self and Self-Regulation: Resolving the SRO Identity Crisis*, 1 BROOK. J. CORP. FIN. & COM. L. 317, 344 (2007) [hereinafter Dombalagian, *Self and Self-Regulation*].

15. 15 U.S.C. § 78o-3(b)(7).

16. *Fiero*, 660 F.3d at 574-75.

17. *Id.*

18. *Id.* at 576.

19. *Id.* at 576-77.

FINRA do not require the assistance of the courts in order to successfully carry out their self-regulatory activities.<sup>20</sup> In our view, that position is based on an as-yet-unanalyzed assumption that FINRA has sufficient power over its industry members to enable FINRA not merely to assess penalties against them, but also to collect and otherwise enforce such penalties.

We argue here that there must be some economic rents (super-competitive profits) associated with an industry in order for the SRO in that industry to be successful in imposing self-regulation absent an ability to invoke various powers of the federal courts to help with enforcement. This is true because if those in a regulated industry were earning only normal rates of return, instead of economic rents, then expulsion would be a matter of indifference and sanctions could be ignored. In this case, expulsion would result merely in a job change for transgressors, who would profit from wrongdoing until caught. Then, the transgressors would simply change professions to another competitive profession in which one earns a normal, competitive rate of return.

Alternatively, an SRO such as FINRA can be made to work effectively on its own without the power of the courts even if member firms are not earning economic rents if the *individuals* in the firm who are subject to the SRO's regulations are themselves earning economic rents. Self-regulation will also work in an industry in which employees must make firm or industry specific investments, thereby making the cost of a disciplinary sanction such as expulsion highly salient. In this case, expulsion would cause any employee who had made such investments to forfeit forever the future returns associated with the investments.

Thus, the principal way that SROs traditionally have been able to enforce their own rules without having to use the government's civil and criminal enforcement power is by maintaining a monopoly and using their credible threat to be able to exclude a participating firm from the cartel as its ultimate enforcement mechanism.

In other words, SROs such as FINRA, in order to enforce their own rules, must have and maintain market power over the industry they are regulating. In his opinion in *Fiero*, Judge Winter seems to have acknowledged this fact when he observed that "[o]ne cannot deal in securities with the public without being a member of FINRA. When a member fails to pay a fine levied by FINRA, FINRA can revoke the

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20. See *id.* at 576 (noting that "significant underenforcement of the securities laws and FINRA rules is hardly the inevitable result of FINRA's inability to bring fine-enforcement actions," and that NASD/FINRA has long relied on its ability to revoke the registrations of non-compliant members).

member's registration, resulting in exclusion from the industry."<sup>21</sup> Judge Winter's premise here is that because FINRA is the only supplier of a service that securities brokers demand (market access), members pay the prices FINRA sets.<sup>22</sup> However, Judge Winter did not seem to acknowledge an additional fact, which is that if perfect or near-perfect substitute employment opportunities exist outside of the industry from which one is expelled, then the threat of sanctions will not influence miscreants' conduct, or will influence it only very marginally.<sup>23</sup>

Our point is that FINRA's ability to exercise market power to compel compliance is neither inevitable, nor static. Said another way, the costs of having one's membership in FINRA revoked is not constant over time (or the same for everyone). In particular, if a member firm that is expelled can redeploy its human and fixed capital in pursuit of alternative activities that are equally profitable to the activities within the SRO's jurisdiction, then the threat of punishment, up to and including fines or expulsion, would not have any deterrent effect whatsoever. For example, if members could simply and costlessly join a rival securities association or participate in the securities industry notwithstanding its lack of membership in FINRA, the threat of expulsion would no longer serve to dissuade members from violating FINRA's rules.

Likewise, if a securities broker's skills, training, and expertise were costlessly transferable to other endeavors such as mortgage origination or selling insurance or commodities, then regulated brokers could forgo paying their fines and instead join new industries. The threat of expulsion incentivizes members to pay fines only to the extent that being deprived of membership in FINRA is costly, and such membership is only costly if FINRA is a monopoly.

On this basis, we argue that an SRO's enforcement power is a function of its market power. As market power goes up, so too does its power over the entities it regulates. Thus, the efficacy of even a monopolist's power to enforce its rules privately without the help of the state is symmetrical with its power to exclude. But because breaking rules is, of course, always perceived to provide a benefit to the rule-breaker, the size of the penalties imposed on a prospective rule-breaker matters, as does the probability that the rule-breaker will be detected.

This Article proceeds as follows: In Part I, we provide a brief overview of FINRA, including its rules and sanctioning policies, and recent criticisms of the SRO. In Part II, we discuss the history of SROs

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21. *Id.*

22. *See id.*

23. *See infra* Part IV.B.2.

and their use of market power to compel member compliance. We also discuss the exchanges' loss of market power and the challenges posed to the exchanges' self-regulatory mission. In Part III, we look at recent trends in the brokerage industry to suggest that FINRA may also be losing market power and the impact this would have on FINRA's deterrence and enforcement regime. In the Conclusion, we suggest possible ways FINRA can improve its ability to deter misconduct and enforce FINRA's disciplinary fines.

## II. OVERVIEW

### A. *Self-Regulation in the Securities Industry*

In 1938, Congress amended the Exchange Act to extend self-regulation to the over-the-counter ("OTC") market.<sup>24</sup> The Maloney Act<sup>25</sup> authorized the Commission to delegate to national associations regulatory oversight of broker-dealers that were not members of a national securities exchange.<sup>26</sup> Like the exchanges', an association's rules must be "designed to prevent fraudulent and manipulative acts and practices" and provide for disciplining members by censure, fine, suspension, expulsion, or any other fitting sanctions for violating the Exchange Act provisions, rules promulgated thereunder, and the association's own rules.<sup>27</sup> The NASD registered in 1939.<sup>28</sup> Although the statute did not restrict the number of associations that could be formed, NASD remained the only one for securities broker-dealers until it was replaced by FINRA in 2007.<sup>29</sup>

Almost seventy years later, NASD and NYSE Regulation, Inc. merged to form FINRA, a single regulator for all securities firms

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24. Maloney Act, Pub. L. No. 75-719, § 15A, 52 Stat. 1070, 1070 (1938) (codified as amended at 15 U.S.C. § 78o-3 (2006)) (amending the Exchange Act "[t]o provide for the establishment of a mechanism of regulation among over-the-counter brokers and dealers").

25. Pub. L. No. 75-719, 52 Stat. 1070 (1938) (codified as amended at 15 U.S.C. § 78o-3 (2006)).

26. *Id.* § 15A(a) (codified as amended at 15 U.S.C. § 78o-3(a)); see also VI LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, *SECURITIES REGULATION* 194-95 (4th ed. 2011).

27. Exchange Act § 15A(b)(7)–(8) (codified as amended at 15 U.S.C. § 78o-3(b)(6)–(8)).

28. LOSS, SELIGMAN & PAREDES, *supra* note 26, at 167-68 (citing Application by Nat'l Ass'n of Sec. Dealers, Inc. for Registration, 5 S.E.C. 627, 627, 633 (1939)).

29. *Id.* at 168 & n.23; Saule T. Omarova, *Rethinking the Future of Self-Regulation in the Financial Industry*, 35 BROOK. J. INT'L L. 665, 693-94 (2010); see also *infra* Parts II.B–C (for the main discussion regarding the implication of there being only one association on FINRA's regulatory capabilities). The National Futures Association registered in 1981 and is considered a limited purpose association. See 15 U.S.C. § 78o-3(k).

conducting business with the public.<sup>30</sup> By that point NASD and NYSE were the only SROs providing member firm regulation.<sup>31</sup> Firms with dual membership had to comply with two—often contradictory—rulebooks and pressed for the merger.<sup>32</sup> The SEC approved the merger in order “to help streamline the broker-dealer regulatory system . . . [and to enhance] oversight of U.S. securities firms and assur[e] investor protection.”<sup>33</sup>

The extent of FINRA’s authority is enormous. The Authority oversees approximately 4380 brokerage firms, and 633,000 registered securities representatives.<sup>34</sup> It supervises eighty percent of U.S. equity trading, monitoring trading on the NYSE, NYSE Arca, NYSE Amex, National Association of Securities Dealers Automated Quotations (“NASDAQ”) Stock Market, and the International Securities Exchange.<sup>35</sup>

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30. The SEC approved the consolidation of NASD and NYSE Regulation, Inc. on July 26, 2007. 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., Exchange Act Release No. 34-56,145 (July 26, 2007), 72 Fed. Reg. 42,169, 42,169-70 (Aug. 1, 2007).

31. *Consolidation of NASD and the Regulatory Functions of the NYSE: Working Towards Improved Regulation: Hearing Before the Subcomm. on Sec. & Ins. & Inv. of the S. Comm. on Banking, Hous., & Urban Affairs*, 110th Cong. 5-6 (2007) [hereinafter *NASD/NYSE Consolidation Hearing*] (statement of Erik Sirri, director, Division of Marketing Regulation, Securities and Exchange Commission). One hundred and seventy of the more than 5000 U.S. broker-dealers conducting business with the public under the supervision of NASD or NYSE were members of both organizations. *Id.* at 6 (statement of Erik Sirri, director, Div. of Mkt. Reg., Sec. & Exch. Comm’n). NASD provided regulatory oversight by contract for NASDAQ Stock Market, the American Stock Exchange, and the International Securities Exchange. *Id.* at 53 (statement of Mary L. Schapiro, chairman & chief executive officer, NASD); see also 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., Exchange Act Release No. 34-56,145 (July 26, 2007), 72 Fed. Reg. at 42,170.

32. *Standard Inv. Chartered, Inc. v. Nat’l Ass’n of Sec. Dealers, Inc.*, 637 F.3d 112, 114-15 (2d Cir. 2011) (per curiam), *cert. denied*, 132 S. Ct. 1093 (2012); *NASD/NYSE Consolidation Hearing*, *supra* note 31, at 51-53 (statement of Mary L. Schapiro, chairman & chief executive officer, NASD).

33. Press Release, Sec. & Exch. Comm’n, SEC Gives Regulatory Approval for NASD and NYSE Consolidation (July 26, 2007), available at <http://www.sec.gov/news/press/2007/2007-151.htm>; see also Jeremy Grant, *Self-Regulator to Oversee US Broker-Dealers*, FINANCIAL TIMES, Nov. 11-12, 2006, at 21 (reporting SEC Chairman Christopher Cox as saying that prior to the merger, “investors were suffering amid ‘needless costs of multiple rule books, duplicative inspections and redundant staff’”). NYSE member organizations that were not already members of NASD were required to join FINRA. See Memorandum from Richard Ketchum, Chief Regulatory Officer, NYSE Regulation to All Members and Member Organizations, No. 07-79 (July 30, 2007), available at <http://www.cecouncil.com/Documents/c0b655be-53bc-4925-b91a-ef8dd40d3556.pdf>. Before that, securities dealers who remained on the NYSE did not have to join NASD. See *Standard Inv. Chartered, Inc.*, 637 F.3d at 114.

34. *About FINRA*, *supra* note 1.

35. *Id.*; FINRA 2010 REPORT, *supra* note 7, at 3, 39. Just as NASD was formerly, the new



FINRA establishes and administers rules relating to qualifications for membership.<sup>36</sup> Its rules extend to the internal operations of its members, requiring certain net capital, employee oversight, and internal compliance regimes.<sup>37</sup> It arbitrates disputes among FINRA members, their employees, and customers.<sup>38</sup>

FINRA administers its rules regarding sales or distributions of securities including underwriting and compensation arrangements, and advertising practices.<sup>39</sup> FINRA also enforces Exchange Act provisions and SEC regulations.<sup>40</sup> It conducts regular and for-cause examinations of its members and investigates suspected misconduct.<sup>41</sup> It holds disciplinary proceedings and imposes disciplinary sanctions.<sup>42</sup> FINRA

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SRO became responsible by contract for the market regulation for NASDAQ Stock Market, the American Stock Exchange, and the International Securities Exchange. 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., Exchange Act Release No. 34-56,145 (July 26, 2007), 72 Fed. Reg. at 42,170. In 2010, NYSE contracted out its market surveillance responsibilities to FINRA as well. *Broker-Dealers: FINRA Now Developing New System for Cross-Market Surveillance, Ketchum Says*, 43 Sec. Reg. & L. Rep. (BNA) 2150 (Oct. 24, 2011). “[S]ecurities exchanges maintain listing requirements for companies issuing securities.” Omarova, *supra* note 29, at 694 n.93.

36. FIN. INDUS. REG. AUTH., *By-Laws art. III*, in FINRA MANUAL (Wolters Kluwer 2012) [hereinafter FINRA MANUAL], available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=1](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1) (use hyperlinks to navigate the various sections of the Manual online); see FINRA BROCHURE, *supra* note 6, at 2, 7.

37. SEC Over-the-Counter Markets Rules, 17 C.F.R. § 240.15c3-1 (2011) (laying out net capital requirements for brokers/dealers); FIN. INDUS. REG. AUTH., *Financial and Operational Rules R. 4110*, in FINRA MANUAL, *supra* note 36; see *id.* at *Responsibilities Relating to Associated Persons, Employees, and Others' Employees R. 3010*.

38. Fin. Indus. Reg. Auth., *Arbitration Overview*, FINRA.ORG, <http://www.finra.org/ArbitrationAndMediation/Arbitration/Overview> (last visited Nov. 5, 2012).

39. FINRA Brochure, *supra* note 6, at 3-4.

40. Joseph McLaughlin, *Is FINRA Constitutional?*, 43 Sec. Reg. & L. Rep. (BNA) 681, 681-82 (Mar. 28, 2011).

41. *Id.* at 683-84.

42. *Fiero v. Fin. Indus. Reg. Auth., Inc.*, 660 F.3d 569, 572 (2d Cir. 2011). The Exchange Act requires that FINRA “provide a fair procedure for the disciplining of members and persons associated with members, the denial of membership to any person seeking membership therein, the barring of any person from becoming associated with a member thereof, and the prohibition or limitation by the association of any person with respect to access to services offered by the association or a member thereof.” Securities Exchange Act of 1934, 15 U.S.C. § 78o-3(b)(8) (2006). Once FINRA issues and files a complaint against a member, the matter goes before a hearing panel which issues a decision. *Code of Procedure R. 9211, 9231, 9268-69*, in FINRA MANUAL, *supra* note 36. Members can appeal final decisions to the FINRA National Adjudicatory Council (NAC), whose decisions can then be appealed to the SEC. *Code of Procedure R.9311, 9349(a), 9370*, in FINRA MANUAL, *supra* note 36; see 15 U.S.C. § 78s(d)(2). The SEC’s decision may then be appealed to the United States Court of Appeals. 15 U.S.C. § 78y(a). In sum, parties have multiple levels available in the appeals process. *In re Series 7 Broker Qualification Exam Scoring Litig.*, 548 F.3d 110, 112-13 (D.C. Cir. 2008).

has almost as many employees as the SEC and its revenues near that of the SEC's budget authorization.<sup>43</sup>

### B. FINRA's Rules and Sanctioning Policy

#### 1. Conduct Rules

FINRA's mission is to protect investors and the integrity of the market "through effective and efficient regulation of the securities industry."<sup>44</sup> The Exchange Act directs that an association's rules be "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade."<sup>45</sup> While many of the FINRA rules parallel Exchange Act requirements, FINRA also imposes on its members the duty to "observe high standards of commercial honor and just and equitable principles of trade."<sup>46</sup> FINRA uses this principle to invalidate manipulative or fraudulent conduct, even where there is no FINRA or SEC rule speaking to the particular conduct.<sup>47</sup>

FINRA also regulates particular member-customer interactions and transactions.<sup>48</sup> Members must conform their advertising material to FINRA's specifications and make certain pre-sale disclosures about their

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43. McLaughlin, *supra* note 40, at 683. In 2009, FINRA booked \$1 billion in revenue, including the \$50 million it collected in fines. *Id.* FINRA has approximately 3300 employees. FINRA BROCHURE, *supra* note 6, at 9.

44. *About FINRA*, *supra* note 1. The Exchange Act authorizes FINRA to promulgate rules to regulate member conduct. See 15 U.S.C. § 78o-3(b). FINRA's duties include:

establishing rules and regulations for FINRA members, including fees and membership requirements; arbitration of disputes among and between FINRA members, associated persons, and customers; regulation of public and private sale or distribution of securities including underwriting arrangements and compensation; establishing policies for clearance and settlement of securities transactions; review of FINRA member advertising practices; administration, interpretation and enforcement of FINRA rules; administration and enforcement of Municipal Securities Rulemaking Board ("MSRB") rules and federal securities laws; establishing standards of proof for violations and sanctions imposed on FINRA members and associated persons in connection with disciplinary actions; administration of FINRA enforcement and disciplinary programs including investigation, adjudication of cases and the imposition of fines and other sanctions; and operation of the Central Registration Depository ("CRD").

1-3 W. REECE BADER, FEDERAL SECURITIES EXCHANGE ACT OF 1934 § 3.05 (Matthew Bender & Co. 2012).

45. 15 U.S.C. § 78o-3(b)(6).

46. *Duties and Conflicts R. 2010*, in FINRA MANUAL, *supra* note 36.

47. See *Duties and Conflicts R. 2020*, in FINRA MANUAL, *supra* note 36 (Fraudulent and manipulative conduct is regulated under FINRA Rule 2020, which prohibits members from effecting or inducing any securities transactions by "means of any manipulative, deceptive or other fraudulent device or contrivance.").

48. *Duties and Conflicts R. 2060, 2100-2150*, in FINRA MANUAL, *supra* note 36.

investment products.<sup>49</sup> Each year, FINRA reportedly “reviews more than 90,000 individual advertisements and communications from firms to investors.”<sup>50</sup> Advertising violations was the largest contributor to the total amount in fines that FINRA imposed in 2011.<sup>51</sup>

FINRA prohibits members from charging excessive mark-ups on clients’ trades.<sup>52</sup> Members must also comply with FINRA’s suitability rule, which prohibits a dealer from recommending a security to the client unless the dealer has reason to believe that the security is “suitable” to the client’s financial situation and needs.<sup>53</sup>

## 2. Sanctions

The Exchange Act and FINRA Rule 8310 authorize FINRA to impose a number of disciplinary sanctions.<sup>54</sup> FINRA may censure, fine, suspend, or expel members.<sup>55</sup> FINRA can also censure or fine individuals associated with FINRA members.<sup>56</sup> FINRA may suspend individuals from associating with members in any or all capacities for a

49. See FINRA BROCHURE, *supra* note 6, at 3.

50. *Id.*

51. See Brian L. Rubin et al., *Annual Sutherland FINRA Sanctions Survey Shows a 51% Jump in Fines in 2011*, SUTHERLAND (Mar. 12, 2012), [http://www.sutherland.com/newsevents/News\\_Detail.aspx?News=1276750e-5346-4135-bfc0-a7970d87db47](http://www.sutherland.com/newsevents/News_Detail.aspx?News=1276750e-5346-4135-bfc0-a7970d87db47). Between 2010 and 2011, the total amount fined for advertising-related violations grew from approximately \$4.75 million to \$21.1 million. *Id.* In 2011, nine cases involving allegedly misleading website advertising materials accounted for almost \$8 million in fines. *Id.* A significant amount of advertising fines over the past three years have arisen from the sale of auction rate securities. *Id.*

52. *Commissions, Mark-Ups and Charges R. 2440, IM-2440-1*, in FINRA MANUAL, *supra* note 36.

53. *Duties and Conflicts R. 2310(b)(2)*, in FINRA MANUAL, *supra* note 36. Suitability-related cases were among the largest contributors to total fines levied by FINRA in 2010. Deborah G. Heilizer et al., *Annual Sutherland FINRA Sanctions Study Shows Enforcement Actions on the Rise*, SUTHERLAND (Feb. 28, 2011), [http://www.sutherland.com/newsevents/News\\_Detail.aspx?News=5bf43ef6-e11d-4d58-815e-930a7e0183e0](http://www.sutherland.com/newsevents/News_Detail.aspx?News=5bf43ef6-e11d-4d58-815e-930a7e0183e0). In 2011, FINRA barred thirty individuals for recommending unsuitable transactions. Deborah G. Heilizer et al., *Sutherland Focus Report #4: FINRA Suitability Sanctions Rise in 2011*, SUTHERLAND (Mar. 16, 2012), [http://www.sutherland.com/newsevents/News\\_Detail.aspx?News=06f6963b-0a7a-4aa0-9a35-0090c43a16e7](http://www.sutherland.com/newsevents/News_Detail.aspx?News=06f6963b-0a7a-4aa0-9a35-0090c43a16e7). FINRA has actively developed the suitability rule. See generally FIN. INDUS. REG. AUTH., PROPOSED RULE CHANGE TO ADOPT FINRA RULES 2090 (KNOW YOUR CUSTOMER) AND 2111 (SUITABILITY) IN THE CONSOLIDATED FINRA RULEBOOK (July 30, 2010), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@rulfil/documents/rulefilings/p121835.pdf>. The SEC prosecutes suitability rule violations under its anti-fraud provisions. See Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b), 78o(c)(1) (2006).

54. See, e.g., 15 U.S.C. § 78o-3(b)(7) (providing for disciplinary measures such as, “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”); *Sanctions R. 8310*, in FINRA MANUAL, *supra* note 36.

55. 15 U.S.C. § 78o-3(b)(7); *Sanctions R. 8310*, in FINRA MANUAL, *supra* note 36.

56. *Sanctions R. 8310(a)(1)–(2)*, in FINRA MANUAL, *supra* note 36.

period of time, or contingent on performance of a specific act.<sup>57</sup> Individuals may also be permanently barred from associating with a FINRA member firm in any or all capacities.<sup>58</sup>

Sanctions are crafted on a case-by-case basis, but FINRA's National Adjudicatory Council provides guidelines that offer a range of appropriate sanctions, as well as factors for FINRA's adjudicators to consider.<sup>59</sup> The Sanction Guidelines make clear that the purposes of the sanctions are chiefly to remedy misconduct, prevent the recurrence of misconduct, and deter future misconduct by others.<sup>60</sup> Adjudicators are directed to consider the deterrence effect of the sanctions.<sup>61</sup> Recidivists, for example, are sanctioned more severely than first-time offenders.<sup>62</sup>

FINRA also uses expulsion to ensure members respect SRO information requests, examinations, disciplinary decisions, and arbitration awards.<sup>63</sup> FINRA Rule 8210, for example, obligates members and associated persons to supply information or testimony upon request and to permit staff to inspect member books and records.<sup>64</sup> Failure to

57. *Sanctions R. 8310(a)(3), 8311*, in *FINRA MANUAL*, *supra* note 36; *FIN. INDUS. REG. AUTH., SANCTION GUIDELINES 3* (2011) [hereinafter *FINRA SANCTION GUIDELINES*], *available at* <http://www.finra.org/web/groups/industry/@ip/@enf/@sg/documents/industry/p011038.pdf>.

58. *Sanctions R. 8310(a)(5)–(6), 8311*, in *FINRA MANUAL*, *supra* note 36; *FINRA SANCTION GUIDELINES*, *supra* note 57, at 3.

59. *FINRA SANCTION GUIDELINES*, *supra* note 57, at 1 (“These guidelines do not prescribe fixed sanctions for particular violations . . . . The guidelines recommend ranges for sanctions and suggest factors that Adjudicators may consider in determining, for each case, where within the range the sanctions should fall or whether sanctions should be above or below the recommended range.”).

60. *Id.* at 2, 10 (“Disciplinary sanctions should be more severe for recidivists.”).

61. *Id.* at 2.

62. *Id.* Thus, the Guidelines advise adjudicators to design sanctions that are “significant enough to prevent and discourage future misconduct by a respondent, to deter others from engaging in similar misconduct, and to modify and improve business practices. Depending on the seriousness of the violations, Adjudicators should impose sanctions that are significant enough to ensure effective deterrence.” *Id.* At different points in NASD's and FINRA's disciplinary history, it has revised its practices in response to perceived shortcomings in the effectiveness of its sanctions to actually deter misconduct. FINRA's predecessor, NASD, for instance felt that the size of the penalties it imposed affected the likelihood that its members would comply with its rules. *See, e.g.*, Proposed Rule Change Relating to Removal of Fine Limitations, Exchange Act Release No. 34-25,883, 41 SEC Docket 405, 405-06 (July 5, 1988). Prior to 1988, NASD's disciplinary fines could not exceed \$15,000 per violation. *Id.* FINRA removed the ceiling because it found that the amount was not sufficiently high to effectively deter misconduct. *Id.*; Order Approving Proposed Rule Change Relating to Removal of Fine Ceilings, Exchange Act Release No. 34-25,999, 41 SEC Docket 868, 869 (Aug. 16, 1988); *see also* NAT'L ASS'N SEC. DEALERS, NOTICE TO MEMBERS 88-75: AMENDMENT ELIMINATING THE FINE LIMITATION IN DISCIPLINARY PROCEEDINGS 95 (Oct. 1988).

63. *See* Ernest E. Badway & Jonathan M. Busch, *Ending Securities Industry Self-Regulation as We Know It*, 57 RUTGERS L. REV. 1351, 1355 (2005) (citing *Investigations R. 8210*, in *FINRA MANUAL*, *supra* note 36).

64. *Investigations R. 8210*, in *FINRA MANUAL*, *supra* note 36.

provide testimony in response to FINRA's formal request is consistently sanctioned, typically with expulsion.<sup>65</sup>

The SEC and federal courts have consistently upheld FINRA's ability to expel members for failing to comply with its investigations.<sup>66</sup> They recognize that in the absence of the threat of expulsion, FINRA would be unable to compel members to cooperate with FINRA investigations, a critical function for FINRA.<sup>67</sup> Members are also expelled for failure to promptly pay disciplinary fines or costs, as well as arbitration awards.<sup>68</sup> Failure to comply may be found inconsistent with just and equitable principles of trade and thus in violation of FINRA Rule 2010.<sup>69</sup>

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65. See Alan Lawhead, *Useful Limits to the Fifth Amendment: Examining the Benefits That Flow from a Private Regulator's Ability to Demand Answers to Its Questions During an Investigation*, 2009 COLUM. BUS. L. REV. 210, 213 & n.6 ("FINRA consistently imposes sanctions on individuals who refuse to provide testimony in response to FINRA's formal request that they do so. The sanction is typically to bar individuals from associating with any FINRA member firm.").

66. See, e.g., Elliot M. Hershberg, Exchange Act Release No. 34-53,145, 87 SEC Docket 436, 436-39 (ALJ Jan. 19, 2006).

67. Lawhead, *supra* note 65, at 276. "FINRA's testimony requirement is an essential investigative tool, and a Registered Person's '[f]ailure to provide information fully and promptly undermines the NASD's ability to carry out its regulatory mandate.'" *Id.* (quoting Michael David Borth, 51 S.E.C. 178, 180 (Dec. 16, 1992)); see also PAZ Sec., Inc. & Joseph Mizrahi, Exchange Act Release No. 34-57,656, 93 SEC Docket (CCH) 47, 49 (Apr. 11, 2008) ("[FINRA's] lack of subpoena power thus renders compliance with Rule 8210 essential to enable [FINRA] to execute its self-regulatory functions."), *appeal denied*, 566 F.3d 1172 (D.C. Cir. 2009); Morton Bruce Erenstein, Exchange Act Release No. 34-56,768, 91 SEC Docket (CCH) 2579, 2585 (Nov. 8, 2007) (finding it "critically important to the self-regulatory system that members and their associated persons cooperate with [FINRA] investigations"), *appeal denied*, 316 F. App'x 865 (11th Cir. 2008); Toni Valentino, Exchange Act Release No. 34-49,255, 82 SEC Docket 602, 605 (Feb. 13, 2004) ("[C]ompliance with [NASD's] rules requiring cooperation in investigations is essential to enable NASD to carry out its self-regulatory functions.").

68. "FINRA may suspend or cancel the membership of any member, or suspend any associated or formerly associated person from association with any member, for failure to comply with an arbitration award or with a written and executed settlement agreement obtained in connection with an arbitration or mediation." SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS: AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 134 (Jan. 2011) [hereinafter SEC STUDY] (citing *By-Laws art. VI § 3(b)*, in FINRA MANUAL, *supra* note 36); NAT'L ASS'N SEC. DEALERS, NOTICE TO MEMBERS 04-57: NON-PAYMENT OF ARBITRATION AWARDS 635-36 (Aug. 2004), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p009798.pdf>; see also *Awards R. 12904(j)*, *13904(j)*, in FINRA MANUAL, *supra* note 36, available at <http://www.sec.gov/news/studies/2011/913studyfinal.pdf> (regarding payment of monetary awards); *Expedited Proceedings R. 9554*, in FINRA MANUAL, *supra* note 36 (regarding failure to comply with an award or settlement). In contrast, "[i]nvestment advisers are not subject to such sanctions." SEC STUDY, *supra*, at 134.

69. SEC STUDY, *supra* note 68, at 82 (citing *Arbitration Procedure 1M-12000*, in FINRA MANUAL, *supra* note 36); see also *Duties and Conflicts R. 2010*, in FINRA MANUAL, *supra* note 36.

### C. Recent Criticisms of FINRA

FINRA has come under significant criticism for its failure to prevent or at least detect multiple, large cases of investor fraud that were uncovered over the course of the recent financial crisis.<sup>70</sup> The SEC, investigating FINRA's monitoring of Bernard Madoff, gave a very unfavorable review of FINRA's examinations and write-ups.<sup>71</sup>

Some argue that FINRA focuses too closely on small-scale local scams while ignoring signals of larger trouble occurring on Wall Street.<sup>72</sup> Critics also charged FINRA with going easy on Wall Street, pointing out the significant drops in the number of disciplinary actions that FINRA filed, as well as in the amount of fines FINRA levied, during the financial crisis.<sup>73</sup> Since 2008, the number of FINRA disciplinary actions has actually increased each year.<sup>74</sup> The 2009 Special Review Committee, established by FINRA's board, cited information

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70. See Ben Protess, *From Defending to Policing Wall Street*, N.Y. TIMES DEALBOOK (Jan. 17, 2011, 8:14 PM), <http://dealbook.nytimes.com/2011/01/17/from-defending-to-policing-wall-street/> [hereinafter Protess, *Policing*]; see, e.g., SEC. & EXCH. COMM'N OFFICE OF INVESTIGATIONS, INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME 175-77 (Aug. 31, 2009) [hereinafter SEC INVESTIGATION], available at <http://www.sec.gov/news/studies/2009/oig-509.pdf>.

71. See SEC INVESTIGATION, *supra* note 70, at 176.

72. See Protess, *Policing*, *supra* note 70.

73. "At the height of the crisis in 2008, FINRA filed 1,073 disciplinary actions, down from 1,204 two years before. Last year, FINRA brought 1,310 cases, but levied \$41 million in fines, roughly half what it collected in 2006." *Id.* Susan Merrill, a former FINRA enforcement chief, responded by stating that simply counting numbers is not the right way to judge. *Id.* FINRA barred 329 individuals in 2011, an increase of more than 14% from 2010, when FINRA barred 288 individuals. Rubin et al., *supra* note 51. FINRA levied fines totaling \$68 million in 2011, a 51% increase from fines levied in 2010, which amounted to \$45 million. *Id.* NASD levied \$38.8 million in 1997; \$27.9 million in 1998; \$40.3 million in 1999; and \$14.3 million in 2000. GENERAL ACCOUNTING OFFICE, SEC AND CFTC: MOST FINES COLLECTED, BUT IMPROVEMENTS NEEDED IN THE USE OF TREASURY'S COLLECTION SERVICE 10 tbl.2 (July 2001). [hereinafter GAO REPORT], available at <http://www.gao.gov/new.items/d01900.pdf>. The amount FINRA levies has increased dramatically:

The number of FINRA's "supersized" fines (\$1 million or more) has dwindled in recent years, from 19 reported in both 2006 and 2007, to ten in 2009, and only six in 2010. Although the number of these large fines grew only to ten in 2011, the total amount of these fines exploded from \$14.2 million in 2010 to more than \$35 million in 2011. This includes five fines of at least \$3 million and a short selling case that resulted in a \$12 million fine.

Rubin et al., *supra* note 51. FINRA "ordered more than \$19 million in restitution to harmed investors." *About FINRA*, *supra* note 1.

74. See Rubin et al., *supra* note 51; see also Deborah G. Heilizer et al., *Annual Review of FINRA Sanctions Finds Disciplinary Slowdown Began to Reverse in 2009*, WALL ST. LAW., Aug. 2010, at 1, available at <http://www.sutherland.com/files/Publication/466dfb40-6f36-49bd-840b-fc2ab8d7f7c4/Presentation/PublicationAttachment/2770c97c-19ca-4f33-ba68-3a9e41e08aaa/2010%20D%20Heilizer%20B%20Rubin%20S%20Gillespie%20-%20Annual%20Review%20of%20FINRA%20Sanctions%20Finds%20Disci.pdf>.

barriers that made it difficult for FINRA to detect the scandals.<sup>75</sup> The report recommended that FINRA have greater access to the SEC's data.<sup>76</sup> It also recommended that FINRA have jurisdiction over SEC-registered Investment Advisors.<sup>77</sup> The day the report was published, FINRA announced that it was establishing an Office of Fraud Detection and Market Intelligence.<sup>78</sup>

FINRA has also protested that its effectiveness should not be measured by the number of disciplinary actions it files or the dollar amount it fines.<sup>79</sup> FINRA coordinates investigations with and often does much behind-the-scenes work for cases that are ultimately prosecuted by the SEC.<sup>80</sup> In 2010, FINRA referred 500 cases of suspected fraud to the SEC and other federal enforcement agencies.<sup>81</sup>

### III. MONOPOLY AND MARKET POWER BY DESIGN

#### A. *Effectiveness of a Self-Regulatory System Based on SROs' Market Power*

##### 1. Exchanges

The self-regulatory framework established by the Exchange Act was predicated on member-run organizations with (1) a self-interest in ensuring fair and orderly markets, and (2) sufficient monopoly over listing firms to make the threat of expulsion costly enough to garner the compliance of their members.<sup>82</sup> Long before the Exchange Act, the

75. See FIN. INDUS. REG. AUTH. SPECIAL REVIEW COMM., REPORT OF THE 2009 SPECIAL REVIEW COMMITTEE ON FINRA'S EXAMINATION PROGRAM IN LIGHT OF THE STANFORD AND MADOFF SCHEMES 1, 3-6 (Sept. 2009) [hereinafter SPECIAL REVIEW COMM. REPORT], available at <http://www.finra.org/web/groups/corporate/@corp/documents/corporate/p120078.pdf>.

76. *Id.* at 75.

77. *Id.* at 71-72.

78. Ben Proless, *For Wall Street Watchdog, All Grunt Work, Little Glory*, N.Y. TIMES DEALBOOK (Dec. 1, 2011, 7:00 PM), <http://dealbook.nytimes.com/2011/12/01/for-wall-street-watchdog-all-grunt-work-little-glory> [hereinafter Proless, *Watchdog*]. The office had 130 people as of December 2011, about a year after the task force was established. *Id.*

79. See Proless, *Policing*, *supra* note 70.

80. See Proless, *Watchdog*, *supra* note 78. Cameron Funkhouser, an executive vice president and head of FINRA's Office of Fraud Detection and Market Intelligence has said about FINRA: "We identify the dots so other people can connect them . . . . We're a clearinghouse of regulatory intelligence." *Id.*

81. *Id.* This would suggest that compounded with the Second Circuit decision, FINRA's enforcement work may be a distraction from the real value they could offer.

82. See Onnig H. Dombalagian, *Demythologizing the Stock Exchange: Reconciling Self-Regulation and the National Market System*, 39 U. RICH. L. REV. 1069, 1090-95 (2005) [hereinafter Dombalagian, *Demythologizing*]. "In the context of stock exchanges, the grant of self-regulatory

member-owned exchanges had a system in place for self-regulation.<sup>83</sup> Congress mobilized to reign in the self-dealing behavior of the exchanges, while exploiting their ability to exercise market power over their members.<sup>84</sup>

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authority was premised on the ability of the exchange to exercise dominant market power in specific securities or geographic areas.” *Id.* at 1091. Congress understood that:

The concept of self-regulation is premised upon an exchange’s ability to use its market power for regulatory purposes, mainly by threatening individual members and listed issuers with termination of their contractual arrangements in case of noncompliance with the rules of the ‘club.’ Using the same power to achieve less public-minded goals is simply the other side of the same coin; while the potential for abuse is disquieting, self-regulation would not be successful without the stick of dominant stock exchange power.

Stavros Gadinis & Howell E. Jackson, *Markets as Regulators: A Survey*, 80 S. CAL. L. REV. 1239, 1254 (2007).

83. Gadinis & Jackson, *supra* note 82, at 1246-47 (“Exchanges constituted an attempt by a group of brokers to take control of trading in certain equities so as to offer more streamlined trading conditions through increased liquidity in exchange for a fee.”). Before the Exchange Act, the exchanges worked to set up the market by seeking “to control the trading members, the stocks to be traded among them, and the rules under which trading would take place.” *Id.* at 1246. They established eligibility criteria and market supervision to ensure reliable trading partners and remove potentially deceitful partners. *See id.* at 1247. The exchanges also maintained listing standards so that stocks traded on their exchanges would act as a signal of quality which would then work to retain issuing firms. *See id.* Gadinis and Jackson explained:

Often, exchanges promulgated rules relating to clearing and settlement of transactions executed through their facilities. In addition, exchanges often undertook a policing role over their markets, monitoring compliance with trading rules, supervising day-to-day trading to identify instances of potential fraudulent or abusive behavior, and often undertaking enforcement actions against their members.

*Id.* at 1248. Macey and Kanda write that:

Confining all trading to a centralized location at which trading patterns can be scrutinized greatly facilitates the ability of the markets to monitor breaches of fiduciary duties by officers and directors. Where monitoring and detecting insider trading is easier, the costs of such activity will be higher, and the incidence of the activity will be lower. Thus, organized stock exchanges can reduce agency costs associated with the separation of ownership and control within large, publicly held firms by lowering the costs of monitoring certain breaches of fiduciary duty by corporate insiders.

Jonathan Macey & Hideki Kanda, *The Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges*, 75 CORNELL L. REV. 1007, 1021 (1990) (footnote omitted).

84. Dombalagian, *Demythologizing*, *supra* note 82, at 1075-76 (“Congress specifically expressed concern over the manipulation and control of quotes and trade information disseminated by the exchanges and over-the-counter markets, as well as the impact of excessive speculation in securities on interstate commerce.”). Congress sought to alter the exchanges so that they no longer ran like “private clubs to be conducted only in accordance with the interests of their members,” but as “public institutions which the public is invited to use for the purchase and sale of securities listed thereon.” H.R. REP. NO. 73-1383, at 15 (1934). “The Exchange Act contained provisions designed to prevent known manipulative practices in the exchange and over-the-counter markets, as well as to regulate exchange members’ trading activity and conflicts of interest.” Dombalagian, *Demythologizing*, *supra* note 82, at 1075. The final legislation was partly the result of compromise with the strongly opposed and powerful industry lobby. *See* Gadinis & Jackson, *supra* note 82, at 1250. However, there were practical reasons for trying to tweak the system that was already in place instead of attempting to build a whole new framework. *Id.* at 1249-51. The SEC lacked capacity to



Under the Exchange Act, the SEC was authorized to register “national securities exchanges” that were to enforce their members’ compliance with the Exchange Act and SEC regulations.<sup>85</sup> Exchanges were to promulgate and enforce rules promoting “just and equitable principles of trade,” and provide procedures for disciplining member misconduct.<sup>86</sup> Congress believed it was in the exchanges’ interest to ensure fair and orderly markets in order to attract and retain issuers.<sup>87</sup>

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oversee trading, stockbrokers, and the listing firms on their own. See Joel Seligman, *Cautious Evolution or Perennial Irresolution: Stock Market Self-Regulation During the First Seventy Years of the Securities and Exchange Commission*, 59 BUS. LAW. 1347, 1347 (2004). “To avoid the ‘impracticality of a burgeoning bureaucracy’ that would be ‘in danger of breaking down under its own weight and proving ineffective,’ Congress settled upon a self-regulatory framework for regulating the activities of stock exchange members.” Dombalagian, *Demythologizing*, *supra* note 82, at 1075-76 (quoting Securities Industry Study: Report of the Subcomm. on Sec. of the S. Comm. on Banking, Hous., and Urban Affairs, S. DOC. NO. 93-13, at 139 (1973) (citation omitted)). The SEC and Congress also recognized that the industry’s superior expertise was needed to ensure that the Exchange Act and SEC rules were developed and implemented with as little disruption to the markets as possible. Seligman, *supra*, at 1347; see also 54 Julia Black, *Decentering Regulation: Understanding the Role of Regulation and Self-Regulation in a ‘Post-Regulatory World,’* in CURRENT LEGAL PROBLEMS 115 (M.D.A. Freeman ed., 2001). The argument is somewhat limited in its applicability to today’s markets, although it continues to be offered. The position assumes that the SROs providing oversight are actually governed by industry participants and not by full-time staff. See Gadinis & Jackson, *supra* note 82, at 1250. It also may be less applicable as the areas of oversight delegated to SROs, such as FINRA, have broadened to encompass review of non-market issues, such as the financial statements of members. *Id.* Another benefit was that as non-governmental entities, SROs could adopt standards higher than those set by federal securities law, prohibiting behavior inconsistent with just and equitable principles. See, e.g., Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1459 (1997).

85. Securities Exchange Act of 1934, 15 U.S.C. § 78f(a), (b)(1) (2006).

86. *Id.* § 78f(b)(6)–(7).

87. Jonathan R. Macey & Maureen O’Hara, *From Markets to Venues: Securities Regulation in an Evolving World*, 58 STAN. L. REV. 563, 570 (2005). Macey and O’Hara explain:

Because market participants were quite homogeneous, there was a significant convergence of interests between exchanges and members with respect to regulation. What was perceived as being in the interests of exchange members was also perceived as being good for the development of the market. And, in turn, what was perceived as being good for the market was also perceived as being good for investors and issuers.

*Id.* Macey and Kanda add:

Over time, stock exchanges have developed significant reputational capital that is of value to listing firms. It is very costly for potential investors to obtain information about all of the companies that present attractive investment opportunities. Listing on an exchange can provide a valuable filter to investors, informing them that the securities listed are of high quality.

This signalling service is valuable to issuers as well as investors. Issuers find it costly to make credible assurances to potential investors that their securities are of high quality.

Macey & Kanda, *supra* note 83, at 1023 (footnote omitted). “As monopolists, exchanges had a strong economic incentive to pass rules that would increase the overall size of the markets for listed securities, as this would increase the exchanges’ overall monopoly profits.” Macey & O’Hara, *supra*, at 570. “Exchanges may come to acquire dominant market power because the aggregation of liquidity creates a natural monopoly or because members naturally benefit from economies of scale

The market power that the exchanges wielded over their members would ensure that their members conducted their businesses according to just and equitable principles of trade.<sup>88</sup> The exchanges' market power in securities enabled the threat of expulsion to garner compliance with Exchange Act provisions, SEC regulations, and the exchanges' own rules.<sup>89</sup>

Congress sought to protect the exchanges' monopoly status, which was necessary to ensure that all securities trading activity was monitored by the designated SROs and so that the threat of expulsion for rule violations would keep exchange members in line.<sup>90</sup> The existence of an OTC market as an unregulated alternative to the exchanges threatened the self-regulatory model.<sup>91</sup> Both the Senate and House reports accompanying the respective bills that were to become the Exchange Act indicated concern that a lack of regulation in OTC trading would attract issuing and trading away from the exchanges to escape regulation.<sup>92</sup>

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or standardization of terms." Dombalagian, *Demythologizing*, *supra* note 82, at 1091. Gadinis and Jackson explain:

These rulemaking, monitoring, and enforcement efforts allowed stock exchanges to develop a 'brand'; listing on the NYSE, for example, confirmed that an issuer was able to meet some of the highest corporate standards on a global scale. The exchange offered to listed companies a 'panoply of rules' to govern their activities. The importance of a brand for an exchange lies in the brand's ability to attract revenue. The NYSE and NASDAQ, for example, have traditionally intensely competed with one another for listing fees. Such competition has recently expanded to competition for trading fees and fees from the sale of market trading information.

Gadinis & Jackson, *supra* note 82, at 1248.

88. See 15 U.S.C. § 78f(b)(5); Dombalagian, *Demythologizing*, *supra* note 82, at 1090-92.

89. Gadinis & Jackson, *supra* note 82, at 1248; Dombalagian, *Demythologizing*, *supra* note 82, at 1091. Gadinis and Jackson explained:

As stock exchange regulatory power was, at least initially, based on contract, the exchanges' sanctioning abilities were structured in a contract-like manner. As such, discontinuation of the contract often constituted the harshest measure over the regulated entity, which was either a trading member or a listed firm. Consequently, the exchange had the power to devise less strict measures that addressed the particular concerns associated with the behavior in question.

Gadinis & Jackson, *supra* note 82, at 1248. Dombalagian added:

Self-regulatory organizations enforce their rules and the federal securities laws using the sanctions available to them—denial of membership and its privileges. While such powers carry with them the threat of anticompetitive behavior, it is the exchange's monopoly power that also gives it the ability to carry out its self-regulatory mission.

Dombalagian, *Demythologizing*, *supra* note 82, at 1091.

90. See Dombalagian, *Demythologizing*, *supra* note 82, at 1090-92.

91. See Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. 151, 162 (2008) [hereinafter Karmel, *Securities SROs*] (explaining that "self-regulation was called into question by stock market abuses, especially in the OTC market").

92. The House report accompanying the bill that was to become the 1934 Act explained that the over-the-counter markets "are of vast proportions and they would serve as a refuge for any business that might seek to escape the discipline of the exchanges; and the more exacting that

As a practical matter, because the OTC market was outside the exchanges' jurisdictions, the fraudulent trading behavior that the Exchange Act sought to address by delegating supervisory authority to the exchanges would continue unmonitored.<sup>93</sup> Moreover, the threat of expulsion from the exchanges would weaken as a deterrent if members no longer needed to transact securities on exchanges.<sup>94</sup> As a potential fallout, the exchanges would be disincentivized from enforcing their rules, as enforcement would lead to greater migration to the OTC market.<sup>95</sup>

## 2. National Securities Associations

In 1938, Congress passed the Maloney Act, which extended self-regulation to the OTC market.<sup>96</sup> The new Section 15A of the Exchange Act directed the Commission to register national securities associations to supervise its member broker-dealers that were not members of an exchange that would be under the SEC's ultimate supervision.<sup>97</sup>

Congress took the system of exchange self-regulation as its model.<sup>98</sup> In crafting the self-regulatory system, the drafters sought to

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discipline, the greater the temptation to escape from it." H.R. REP. NO. 73-1383, at 15-16 (1934) (citation omitted). The Senate report echoed this sentiment, seeing the need to "forestall widespread evasion of stock exchange regulation by the withdrawal of securities from listing on exchanges, and by transferring trading therein to 'over-the-counter' markets where manipulative evils could continue to flourish, unchecked by any regulatory authority." S. REP. NO. 73-792, at 6 (1934); *see also* 15 DAVID A. LIPTON, *BROKER DEALER REGULATION* § 1:3 (2012).

93. *See* H.R. REP. NO. 73-1383, at 16 (citation omitted) (explaining that through the Exchange Act, Congress permitted the Commission to require the registration of broker-dealers that were not members of an exchange and that transacted in over-the-counter securities, because "[t]o leave the over-the-counter markets out of a regulatory system would be to destroy the effects of regulating the organized exchanges"); *see also* LIPTON, *supra* note 92, at § 1:3.

94. *See* S. REP. NO. 73-792, at 6 (noting that companies would evade stock exchange regulation by simply transferring securities to OTC markets).

95. *See id.*; *see also* LIPTON, *supra* note 92, at § 1:3.

96. Pub. L. No. 75-719, § 15A, 52 Stat. 1070, 1070 (1938) (codified as amended at 15 U.S.C. § 78o-3 (2006)).

97. *Id.* In a 1936 prelude to the eventual Maloney Act, the SEC obtained authority to "regulate broker-dealers for record keeping and financial responsibility and to prohibit fraudulent activity in the over-the-counter market." Dombalagian, *Demythologizing*, *supra* note 82, at 1076 n.35; *see also* LIPTON, *supra* note 92, at § 1:1.

98. *See* LOSS, SELIGMAN & PAREDES, *supra* note 26, at 160 (citing 83 CONG. REC. 4451 (1938) (statement of Sen. Francis T. Maloney)); S. REP. NO. 75-1455, at 3-4 (1938); H.R. REP. NO. 75-2307, at 4-5 (1938)). Like the exchange framework, the OTC model would be one of cooperative regulation:

in which the [regulatory] task will be largely performed by representative organizations of investment bankers, dealers, and brokers, with the Government exercising appropriate supervision in the public interest, and exercising supplementary powers of direct regulation. In the concept of a really well organized and well-conducted stock exchange, under the supervision provided by the Securities Exchange Act of 1934, one may perceive something of the possibilities of such a program.

replicate the economic effect of expulsion from the SRO exchanges.<sup>99</sup> The Maloney Act enabled national securities associations to increase the value of membership and thus compel OTC brokers to join by allowing associations to promulgate a rule allowing members to deal on preferential terms with each other while prohibiting members “from dealing with nonmember broker-dealers except on the same terms as are accorded to the general public.”<sup>100</sup> As the Senate report explained:

[I]t is contemplated that exclusion from membership in a registered securities association will be attended and implemented by economic sanctions. In this respect, exclusion from such an association would be comparable in effect to expulsion from a national securities exchange. It is these economic sanctions which would make possible effective discipline within the association.<sup>101</sup>

According to the SEC, the provision made it “virtually impossible for a dealer who is not a member of the NASD to participate in a distribution of important size.”<sup>102</sup> Roberta Karmel credits the preferential terms as the main reason for membership in NASD.<sup>103</sup>

In 1939, NASD became the first and only securities association to register with the SEC to oversee broker-dealers in the OTC market.<sup>104</sup> Although the Act provided for the registration of multiple associations, academics have suggested that the Act’s drafters never intended that more than one association be formed, and that “[t]he SEC itself encouraged the formation of a single, national association.”<sup>105</sup> In 1955,

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S. REP. NO. 75-1455, at 4; H.R. REP. NO. 75-2307, at 4-5. In important ways though, the Maloney Act constrained NASD’s ability to engage in anticompetitive behavior—much more than the original Act constrained that of the exchanges. Dombalagian, *Demythologizing*, *supra* note 82, at 1077. For instance, NASD was not allowed to impose a schedule of prices or fix minimum commissions. *Id.* NASD’s role was narrower and SEC’s leash on the association was shorter. *Id.*

99. See Securities Exchange Act of 1934, 15 U.S.C. § 78o-3(b)(7) (2006).

100. 15 U.S.C. § 78o-3(e); Dombalagian, *Demythologizing*, *supra* note 82, at 1077; Karmel, *Securities SROs*, *supra* note 91, at 161-62 (“[M]uch of what held the NASD together was the economic self-interest of securities dealers in structuring the trading rules for the OTC market.”). FINRA no longer operates the OTC market, which was organized into NASDAQ in 1971 and then separated from NASD, into a public company and registered with the SEC as a stock exchange. *Id.* at 161.

101. S. REP. NO. 75-1455, at 3-4.

102. Nat’l Ass’n Sec. Dealers, Inc., 19 S.E.C. 424, 441 (1945).

103. See Karmel, *Securities SROs*, *supra* note 91, at 162.

104. See LOSS, SELIGMAN & PAREDES, *supra* note 26, at 168 & n.23; Dombalagian, *Demythologizing*, *supra* note 82, at 1077 n.36; Karmel, *Securities SROs*, *supra* note 91, at 159, 161.

105. LOSS, SELIGMAN & PAREDES, *supra* note 26, at 168 n.21 (citing H.R. DOC. NO. 88-95, pt.4, at 606 (1963)); BADER, *supra* note 44, at § 3.05 n.3. The Maloney Act contemplated multiple SROs registering. Dombalagian, *Self and Self-Regulation*, *supra* note 14, at 348. The National Futures Association (“NFA”), formed for the limited purpose of regulating futures products, was the second association to apply for registration, sixty years after NASD. LOSS, SELIGMAN & PAREDES,

the Executive Director of the NASD testified that its membership “covered practically every one that was in the securities business, as we know it.”<sup>106</sup>

Over the years, the SEC and Exchange Act amendments expanded the class of broker-dealers required to register with a national securities association.<sup>107</sup> The last exemptions were removed in 1983.<sup>108</sup> Today, the Exchange Act requires that all brokers and dealers required to register with the SEC must also register with a national securities association in order to effect any transactions in securities.<sup>109</sup>

## B. GOVERNMENT RESTRAINTS ON ANTI-COMPETITIVE BEHAVIOR AND NEW COMPETITION UNDERMINE EXCHANGES’ ABILITY TO EXERCISE MARKET POWER

### 1. Anti-Competitive Behavior Restrained

Since the passage of the Exchange Act, governmental efforts to restrain the exchanges’ perceived anti-competitive behavior and the emergence of non-exchange as well as international trading venues have

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*supra* note 26, at 168 n.23. “But it was clear that another association might be formed.” *Id.* at 168 n.21 (citing S. Rep. No. 88-379, at 49-50 (1963)).

106. LOSS, SELIGMAN & PAREDES, *supra* note 26, at 168, 170 (quoting *Amendments to Securities Act of 1933 (Exemptions): Hearings on H.R. 5701 and H.R. 9319 Before the Subcomm. on Commerce & Fin. of the H. Comm. on Interstate & Foreign Commerce*, 84th Cong. IV, 682 (1956) (internal quotation marks omitted) (testimony of Wallace H. Fulton, Executive Director, National Association of Securities Dealers, Inc.)).

107. Even before the Maloney Act, the new registration requirements in the 1936 amendments broadened the scope of broker-dealers required to register under SEC’s rules. *See* David A Lipton, *A Primer on Broker-Dealer Registration*, 36 CATH. U. L. REV. 899, 902-03 (1987). The rules had initially focused on brokers and dealers that made markets in over-the-counter securities or used such facilities to transact. *Id.* This distinction was removed in the amendments—after the 1936 amendments codifying the SEC’s rules requiring registration of OTC brokers and dealers, the Commission required even exchange members to register if they merely engaged in over-the-counter transactions. *See id.* at 903. “The Commission interpreted § 15(a) as authority to require registration of any broker or dealer who engaged in *any* over-the-counter transaction, whether or not that broker or dealer was an exchange member.” *Id.* at 903 n.13. “Many stocks, whether listed or unlisted, as well as virtually all bonds and government securities, traded in the ‘over-the-counter’ market . . .” Dombalagian, *Demythologizing*, *supra* note 82, at 1076 n.35.

108. *See* Order Granting Accelerated Approval of Proposed Rule Change: Conversion of SECO Broker/Dealers, Exchange Act Release No. 20,273, 28 SEC Docket 1366, 1366-67 (Oct. 12, 1983) (converting SECO broker-dealers (i.e., those who were registered with the SEC) into members of NASD). Congress had previously allowed some investment companies that had “objected strenuously to the principle of compulsory membership in any trade association” to be regulated by the SEC directly. LOSS, SELIGMAN & PAREDES, *supra* note 26, at 193 (citing H.R. REP. NO. 88-1418, at 2-3 (1964)).

109. LIPTON, *supra* note 92, at § 1:3 & n.2. “The act also provides that the SEC may exempt from registration any broker or dealer, or class of brokers or dealers.” 69 AM. JUR. 2D *Securities Regulation—Federal* § 335 (2008); *see, e.g.*, LIPTON, *supra* note 92, at § 1:3.

undermined the ability of the exchanges to regulate themselves.<sup>110</sup> The inherent conflict of interest in the member-owned exchanges acting as regulators over themselves continued to irk Congress and the SEC.<sup>111</sup> In a number of instances over the years, the exchanges proved lax in fulfilling their regulatory mission and were even complicit in marketplace misconduct, using their regulatory power to promote members' interests.<sup>112</sup> Many saw the exchanges, particularly the NYSE, as using their regulatory power to prevent competition.<sup>113</sup> For example, for many years the NYSE prohibited its members from trading NYSE-listed stock in the OTC market.<sup>114</sup> The control of NYSE's management by specialists explained to many the reason why specialists remained long after trading technology should have made them obsolete.<sup>115</sup>

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110. See Dombalagian, *Self and Self-Regulation*, *supra* note 14, at 328, 331-32.

111. See Concept Release Concerning Self-Regulation, Exchange Act Release No. 34-50,700, 69 Fed. Reg. 71,256, 71,258-59 (Dec. 8, 2004) ("Likewise, numerous recent SRO failings related to governance, member oversight and trading supervision raise significant concerns about the efficacy of the self-regulatory model.").

112. See *id.* at 71,258. According to a 1973 report of the Senate Subcommittee on Securities:

The inherent limitations in allowing an industry to regulate itself are well known: the natural lack of enthusiasm for regulation on the part of the group to be regulated, the temptation to use a facade of industry regulation as a shield to ward off more meaningful regulation, the tendency for businessmen to use collective action to advance their interests through the imposition of purely anticompetitive restraints as opposed to those justified by regulatory needs, and a resistance to changes in the regulatory pattern because of vested economic interests in its preservation.

Seligman, *supra* note 84, at 1347 (quoting S. DOC. NO. 93-13, at 145 (1973)). The U.S. government has nonetheless continued to delegate significant regulatory authority to them. Karmel, *Securities SROs*, *supra* note 91, at 162. Karmel explained:

Although the efficacy of self-regulation was called into question by stock market abuses, especially in the OTC market, the 1963 SEC Special Study concluded that self-regulation should be maintained and strengthened. Self-regulation was similarly questioned in the mid 1970s, but the Securities Act Amendments of 1975 continued the role of stock exchanges and the NASD as SROs.

*Id.*

113. Gadinis & Jackson, *supra* note 82, at 1253-56 (explaining the perceived "potential for conflicts of interest inherent in a grant of regulatory powers to an organization representing, essentially, the regulated entities themselves" and that "self-regulation acts as a shield 'insulating' the industry it purports to regulate from government intervention that enhances investor protection, albeit at a cost to industry members"). "In the United States, there has been a long history of controversies over perceived anticompetitive practices, whereby major exchanges, particularly the NYSE, exploited their market power to extract monopoly rents." *Id.* at 1254 (citing *Gordon v. N.Y. Stock Exch., Inc.*, 422 U.S. 659, 660-61, 665-66, 681-82 (1975); *Silver v. N.Y. Stock Exch., Inc.*, 373 U.S. 341, 343-45, 359-60 (1963)).

114. Seligman, *supra* note 84, at 1365 (discussing "NYSE Rule 394, later Rule 390, which in effect prohibited NYSE members from trading NYSE issued stocks in the over the counter ('OTC') market"); see Gadinis & Jackson, *supra* note 82, at 1254-55.

115. Gadinis & Jackson, *supra* note 82, at 1254-55. Gadinis and Jackson continued:

According to some scholars, the central part that specialists have maintained on the floor

Over the years, the exchanges, including NASDAQ,<sup>116</sup> were forced to abandon rules that enabled them to maintain monopolies.<sup>117</sup> The 1975 Exchange Act amendments sought to facilitate the development of a National Market System, the objective of which was to maximize competition among market members, between exchanges and broker-dealers.<sup>118</sup> After the market-making price collusion scandal on NASDAQ<sup>119</sup> and the NYSE specialist misconduct,<sup>120</sup> both markets were

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of the NYSE illustrates the following scenario: specialists, which have managed to survive by virtue of the NYSE mutual ownership structure that allows specialists to control NYSE management, are part of an outdated institution surpassed by modern trading designs.

*Id.*

116. With the Commission's encouragement, NASD developed the NASDAQ system in 1971 to coordinate over-the-counter trading in a centralized system. Christopher W. Cole, Note, *Financial Industry Regulatory Authority (FINRA): Is the Consolidation of NASD and the Regulatory Arm of NYSE a Bull or a Bear for U.S. Capital Markets?*, 76 UMKC L. REV. 251, 256 (2007). Until then, NASD had exclusively been a regulatory organization. *See id.* at 255.

117. *See* Roger D. Blanc, *Intermarket Competition and Monopoly Power in the U.S. Stock Markets*, 1 BROOK. J. CORP. FIN. & COM. L. 273, 287 (2007); Karmel, *Securities SROs*, *supra* note 91, at 162.

118. Laura Nyantung Beny, *U.S. Secondary Stock Markets: A Survey of Current Regulatory and Structural Issues and a Reform Proposal to Enhance Competition*, 2002 COLUM. BUS. L. REV. 399, 411-12. NMS was designed to achieve:

- (i) economically efficient execution of securities transactions;
- (ii) fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;
- (iii) the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities;
- (iv) the practicability of brokers executing investors' orders in the best market; and
- (v) an opportunity, consistent with the provisions of clauses (i) and (iv) of this subparagraph, for investors' orders to be executed without the participation of a dealer.

Securities Exchange Act of 1934, 15 U.S.C. § 78k-1(a)(1)(C) (2006). To achieve that, Congress felt that it was necessary to optimize competition among exchanges and to prevent the exchanges from exercising monopolistic control over information (e.g., market data). *See* Blanc, *supra* note 117, at 287. Blanc explained:

In fashioning the Securities Acts Amendments of 1975, which added the national market system provisions in section 11A of the Exchange Act, the Congress was alert[ed] to the risk that exchanges, as government-protected monopolies, could exert monopoly power over market data. It warned that the exchanges—if allowed to continue to have monopoly powers—should be regulated as public utilities . . . .

*Id.* The 1975 amendments increased the SEC's oversight of the SROs, prohibiting certain anti-competitive behavior, requiring greater independence of its governance leaders, and requiring separation of market and regulatory functions. The SEC was also given authority to initiate and approve SRO rule-making, and to participate, monitor, and even enforce SRO enforcement and discipline. Karmel, *Securities SROs*, *supra* note 91, at 162. The amendments also addressed SRO board composition, requiring that there be at least one independent board member that represents issuers and investors. *Id.*

119. In 1994, the Justice Department's Antitrust Division investigated "the possibility of anticompetitive practices in the over-the-counter stock market." *Id.* (citations omitted) (internal quotation marks omitted). After the Department of Justice and the SEC discovered an extensive market-maker price fixing scheme on NASDAQ, NASD was forced to separate its market and

required to separate their regulatory arms from their market operations, leading to the increasing bureaucratization of industry self-regulation and independence from market-centered incentives.<sup>121</sup> The exchanges

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regulatory operations into two subsidiaries—NASDAQ and NASD Regulation, Inc. (“NASDR”). Seligman, *supra* note 84, at 1369-72. The 1995 NASD Select Committee on Structure and Governance found that “regulation of the broker-dealer profession should otherwise be separated from and performed independently of regulation of the NASDAQ and other OTC markets.” NAT’L ASS’N SEC. DEALERS, INC., NOTICE 95-84: RUDMAN COMMITTEE RELEASES SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS 2 (1995). The Commission later instituted administrative proceedings against NASD in 1996, alleging OTC market-maker pricing collusion. Order Instituting Public Proceedings Pursuant to Section 19(h)(1) of the Securities Exchange Act of 1934, Making Findings and Imposing Remedial Sanctions, Exchange Act Release No. 34-37,538, 62 SEC Docket 1346, 1346-47 (Aug. 8, 1996). The Commission was particularly distressed by the lack of independence of the NASD regulatory staff from NASDAQ’s market operations. *See id.*; SEC. & EXCH. COMM’N, REPORT PURSUANT TO SECTION 21(A) OF THE SECURITIES EXCHANGE ACT OF 1934 REGARDING THE NASD AND THE NASDAQ MARKET 40-46 (1996) [hereinafter SECTION 21(A) REPORT]; *see also* Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market, Exchange Act Release No. 37,542, (Aug. 8, 1996), available at 1996 WL 452691 at \*2 (finding that NASD was “unduly influenced by NASDAQ market making firms with respect to rulemaking, the disciplinary process and the admission of new members”). In his memoir, SEC Director Arthur Levitt admitted that the SEC had “failed to see that the NASD had gradually been taken over by a cabal of dealers who used the NASD’s disciplinary process to punish certain players, such as day traders, while failing to prosecute serious infractions by market-makers.” ARTHUR LEVITT, TAKE ON THE STREET 184 (2002). The restructuring of NASD was part of the settlement arising from the SEC action against NASD. SECTION 21(A) REPORT, *supra*, at 50-55; NASD sold NASDAQ in 2000 and 2001 after years of investigation into and complaints about the inherent conflict of interest. Cole, *supra* note 116, at 257.

120. *E.g.*, Press Release, U.S. Att’y, S.D.N.Y., 15 Current and Former Registered Specialists of the N.Y. Stock Exch. Indicted on Federal Securities Fraud Charges (Apr. 12, 2005), available at <http://www.justice.gov/usao/nys/pressreleases/April05/specialistindictmentpr.pdf>. Widespread violations of federal securities law by NYSE specialists were uncovered in the early 2000s. Like NASD, NYSE underwent a number of governance reforms to increase the independence of its board and segregate its market and regulatory operations. Order to Reform the Governance and Management Architecture of the Exchange, Exchange Act Release No. 34-48,946 (Dec. 17, 2003), 68 Fed. Reg. 74,678, 74,678-79 (Dec. 24, 2003); Concept Release Concerning Self-Regulation, Exchange Act Release No. 34-50,700, 69 Fed. Reg. 71,256, 71,260 (Dec. 8, 2004) (“Recently, the NYSE changed its governance structure to reduce conflicts of interest with respect to members. Specifically, the NYSE created a wholly independent board and regulatory staff that report to an independent board committee.” (footnote omitted)). When NYSE merged with Archipelago Holdings, Inc. (“Arca”) shortly thereafter, NYSE’s regulatory functions were moved into a separate not-for-profit subsidiary. Order Granting Accelerated Approval to Amendment Nos. 6 and 8 Relating to the NYSE’s Business Combination with Archipelago Holdings, Inc., Exchange Act Release No. 34-53,382 (Feb. 27, 2006), 71 Fed. Reg. 11,251, 11,254-55 (Mar. 6, 2006). NYSE was demutualized and made a public company through its merger with Arca. *Id.*

121. *See* Fair Administration and Governance of Self-Regulatory Organizations, Exchange Act Release No. 34-50,699, 69 Fed. Reg. 71,126, 71,129-31 (proposed Dec. 8, 2004) (to be codified at 17 C.F.R. pts. 240, 242, 249); Dombalagian, *Self and Self-Regulation*, *supra* note 14, at 333 (“The Commission has also proposed to revamp the rules of exchange governance to require greater transparency and segregation of the regulatory and trading operations of SROs.”); Order Granting Accelerated Approval to Amendment Nos. 6 and 8 Relating to the NYSE’s Business Combination with Archipelago Holdings, Inc., 71 Fed. Reg. at 11,252; Badway & Busch, *supra* note 63, at 1369-70 (“[A]ny legitimate reforms to the SRO system must begin by separating the market from



were required to give up their rule requiring consolidation of order flow through them, mandatory minimum commission schedules, off-board trading prohibitions, and restrictions on the delisting of firms.<sup>122</sup> Once the exchanges were prohibited from mandating consolidation of order flow through their facilities or restricting their members from off-board trading, the exchanges were effectively deprived of their ability to discipline their members.<sup>123</sup>

## 2. Exchanges Lose Market Share to Competition

The U.S. markets and their traditional securities exchanges faced increasing competition from alternative trading systems (“ATs”) and cross-border markets.<sup>124</sup> The NYSE, once boasting seventy-seven

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regulatory functions.”); Gadinis & Jackson, *supra* note 82, at 1263 (“While the solutions each proposal favors are very different, they all share a common underlying rationale: to alleviate conflicts of interest by segregating market operation from market regulation.”). A similar scenario played out in the UK, where the government abandoned its self-regulatory framework. *Id.* at 1256 (“In the late 1990s, the U.K. government felt that the SRO system generated such complexity and inefficiency that it decided to transfer SRO regulatory powers to the Federal Securities Administration (the ‘FSA’).”).

122. Dombalagian, *Self and Self-Regulation*, *supra* note 14, at 328 (“[O]ver the past seventy years the Commission has cajoled or required the primary exchanges to abandon mandatory minimum commission schedules, off-board trading prohibitions (both with respect to other exchanges and the over-the-counter market), and restrictions on the ability of management or shareholders to delist companies from an exchange.”); see also Beny, *supra* note 118, at 412; Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SMU L. REV. 325, 347-52 (2001); Omarova, *supra* note 29, at 695-96.

123. See Dombalagian, *Self and Self-Regulation*, *supra* note 14, at 328. Dombalagian explained:

[T]he Commission’s significant rulemaking in the area of *market structure* has considerably undermined the autonomy of exchanges to regulate the structure of their own market operations. The justification for conferring disciplinary authority on exchanges is their comprehensive ability to oversee and control participation in trading through their facilities; the power to exclude subsumes the power to discipline. Once exchanges are no longer able—or permitted—to mandate consolidation of order flow through their facilities, the source of self-regulatory authority wanes considerably.

*Id.* Macey and Kanda add:

[E]ven so-called off-board trading restrictions, which prohibit exchange members from trading shares in listed securities in the over-the-counter market, are eroding. SEC Rule 19c-3 prohibits exchanges from restricting secondary market trading for shares listed on an exchange after April 26, 1979. For these stocks, the NYSE faces potential competition from the over-the-counter markets for trading volume because members can begin making markets for over-the-counter shares in these firms. This competition serves as a real constraint on the ability of the NYSE to exercise market power over certain listed firms.

Macey & Kanda, *supra* note 83, at 1025 (footnotes omitted).

124. See Beny, *supra* note 118, at 469; PRICEWATERHOUSECOOPERS LLP, FS REGULATORY BRIEF: NEW SEC RULE 15C3-5 BANS UNFILTERED MARKET ACCESS, CREATES NEW CEO CERTIFICATION, RISK MANAGEMENT, SUPERVISORY AND COMPLIANCE, AND OPERATIONAL OBLIGATIONS FOR BROKER-DEALERS 1-2 (2011), available at <http://www.pwc.com/us/en/financial->

percent of all U.S. equity trading, is facing increasing competition from alternative trading systems and international exchanges.<sup>125</sup> This trend has heightened concerns that the SRO system, in its present form, is no longer capable of garnering the compliance of its members.<sup>126</sup>

Exchanges, which, as SROs, oversaw the trading activities of their members, no longer dominate trading.<sup>127</sup> Brokers and broker-dealers can now provide “marketplaces for securities themselves, establishing electronic trading networks outside of traditional stock exchanges.”<sup>128</sup>

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services/regulatory-services/publications/assets/FS-Reg-Brief-sponsored-access.pdf. “In 1998, the SEC adopted Rule 3b-16 to define which automated trading systems were exchanges, and Regulation ATS to exempt certain automated trading systems from registration as an exchange, subject to conditions that applied the core elements of exchange regulation to exempted ‘alternative trading systems.’” DAVIS POLK & WARDWELL LLP, CURRENT MARKET STRUCTURE ISSUES IN THE U.S. EQUITY AND OPTIONS MARKETS 2 (Feb. 2012), available at <http://www.finra.org/web/groups/industry/@ip/@edu/@mat/documents/education/p126207.pdf>. As early as 1990, Jonathan Macey and Hideki Kanda brought to light the development of services that were substitutable for the New York and Tokyo Stock Exchanges. Macey & Kanda, *supra* note 83, at 1008-09 (“[A] variety of market devices that previously seemed wholly unrelated to the exchanges are in fact close substitutes for those offered by the exchange. . . . [T]he exchanges face significant competition for the services they offer.”).

125. Macey & Kanda, *supra* note 83, at 1024 (“NYSE clearly enjoys a dominant position among U.S. securities exchanges. ‘The value of trading on the NYSE represents 77% of total value of U.S. equity trading activity,’ and is three times greater than the trading value of any other U.S. exchange.”); see also Jeremy Grant, *Sweeping Changes Are on the Way*, FIN. TIMES, Oct. 21, 2009, at 3; Michael MacKenzie, *High Frequency Trading Dominates the Debate*, FIN. TIMES, Oct. 21, 2009, at 3. The SEC described the situation in its 2004 Concept Release, which proposed an overhaul of the self-regulatory system:

[T]he NYSE and Amex historically dominated trading in their listed securities, and market makers dominated trading in NASDAQ stocks. Today, however, in the NASDAQ market, automated market centers (such as NASDAQ’s order collector, aggregator, and execution system, SuperMontage, the Archipelago exchange (“ArcaEx”), and the INET ECN) have captured more than 50% of share volume.

Concept Release Concerning Self-Regulation, 69 Fed. Reg. at 71,258. In 2005, NYSE executed 80% of the volume in its listed stocks. Mary L. Schapiro, Chairman, Sec. & Exch. Comm’n, Speech at the Economic Club of New York: Strengthening Our Equity Market Structure (Sept. 7, 2010), available at <http://www.sec.gov/news/speech/2010/spch090710mls.htm>. By 2010, that figure had dropped to 26%. *Id.* As SEC Chairman Mary Shapiro explained: “The remaining volume is split among more than 10 public exchanges, more than 30 dark pools, and more than 200 internalizing broker-dealers.” *Id.*

126. See Dombalagian, *Demythologizing*, *supra* note 82, at 1087-89; Badway & Busch, *supra* note 63, at 1358-59, 1364-65 (citing Robert Kuttner, *The Big Board: Crying Out for Regulation*, BUS. WK., Oct. 13, 2003, at 26) (arguing that deregulation of the securities industry has led to the weakening of regulation authority by SROs).

127. See Badway & Busch, *supra* note 63, at 1358-59; Iris H-Y Chiu, *Securities Intermediaries in the Internet Age and the Traditional Principal-Agent Model of Regulation: Some Observations from European Union Securities Regulation*, 2 VA. L. & BUS. REV. 307, 318 (2007).

128. Chiu, *supra* note 127, at 318; Dombalagian, *Self and Self-Regulation*, *supra* note 14, at 331 (“[T]echnology made pure brokerage profitable. New electronic trading systems capitalized on technological improvements to offer more efficient, if non-traditional, venues for trade execution without sponsoring the intermediation of a dealer.”).

ATSS and electronic communications networks (“ECNs”) have used technology to provide a low-cost alternative.<sup>129</sup> The regulatory costs that the exchanges face have not encumbered these alternatives.<sup>130</sup> To encourage their proliferation, the SEC did not require that they register as exchanges, but rather as broker-dealers.<sup>131</sup> The mutually-owned exchanges also faced the self-interest of the specialists.<sup>132</sup>

Competition for listings has come from abroad as well.<sup>133</sup> In a 2006 interim report, the Committee on Capital Markets Regulation (also known as the Paulson Committee) found “that the United States is losing its leading competitive position as compared to stock markets and financial centers abroad.”<sup>134</sup>

The multiplicity of trading venues has crippled exchanges’ abilities to exercise market power to discipline members as well as their ability to

129. Macey & O’Hara, *supra* note 87, at 570-71. Macey and O’Hara wrote:

Because of the reduction in transaction costs, particularly with regard to the acquisition and deployment of the technology and communications systems needed for trading and for monitoring trading, exchange members such as Goldman Sachs and Merrill Lynch not only participate directly in the operation of the stock exchange but simultaneously *compete* with the stock exchanges, both by internalizing order flow on the buy and sell side of the same transaction and by offering ECNs and ATSS that directly compete with the exchanges for order flow from third parties.

*Id.*

130. Gadinis & Jackson, *supra* note 82, at 1260 (“[C]ontinuing to demand existing exchanges to invest in their regulatory efforts puts them at a grave disadvantage against newcomers.”).

131. Dombalagian, *Self and Self-Regulation*, *supra* note 14, at 331-32. Dombalagian explained: Virtually all of these systems were permitted to operate as registered broker-dealers in the United States, rather than as exchanges, in order to facilitate their proliferation. . . . To the extent that many brokerage firms were investing in competing execution or market making technologies, exchange members increasingly found themselves in direct competition with their regulators.

*Id.*

132. *Id.* at 332 (“The mutual structure of the primary exchanges, encumbered as it was by members’ (and in particular, specialists’) self-interest, prevented the adoption of new execution technologies in favor of traditional intermediated trading.”).

133. Macey & Kanda, *supra* note 83, at 1025 (quoting Lawrence Harris, *The Dangers of Regulatory Overreaction to the October 1987 Crash*, 74 CORNELL L. REV. 927, 936 (1989)). According to Macey and Kanda:

[E]quity trading that occurs on the floor of the NYSE can easily shift overseas. For example, on October 19, 1987, the day of the most recent market crash, one billion dollars of American stocks were traded in London before the New York markets opened. This “shows that American securities markets are vulnerable to foreign competition on a meaningful scale.”

*Id.* (footnote omitted) (quoting Lawrence Harris, *The Dangers of Regulatory Overreaction to the October 1987 Crash*, 74 CORNELL L. REV. 927 (1989)).

134. John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 234 (2007) (quoting COMM. ON CAPITAL MKTS. REG., INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION ix (Nov. 30, 2006), available at [http://www.capmktreg.org/pdfs/11.30Committee\\_Interim\\_ReportREV2.pdf](http://www.capmktreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf) (internal quotation marks omitted)).

monitor individual member firms.<sup>135</sup> The threat of expulsion from one venue can no longer function to deter misconduct.<sup>136</sup>

Some predict exchanges will reduce the rigor with which they enforce their rules so as to prevent the migration of trading.<sup>137</sup> Jonathan Macey and Maureen O'Hara describe a free-rider situation that leads to the underproduction of regulation.<sup>138</sup> Industry observers speculate that

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135. See Macey & Kanda, *supra* note 83, at 1011-12. According to Macey and Kanda: While these technological developments have not rendered the organized exchanges obsolete by any means, they have allowed for the emergence of over-the-counter and other computer-linked securities markets as substitute providers of liquidity. These markets, particularly the National Association of Securities Dealers Automated Quotations ("NASDAQ"), have deprived the exchanges of any significant market power over listing firms.

*Id.* (footnote omitted). They continued:

[W]hile organized exchanges were historically the sole providers of these services, over time a wide variety of close substitutes has developed. While these close substitutes generally are not exchanges themselves, they nevertheless directly compete with the organized exchanges. Due to the emergence of these substitutes, it no longer is appropriate to view the organized exchanges as monopolies. Instead, they should be perceived and regulated as members of a highly competitive industry.

*Id.* at 1010. Gadinis and Jackson explained:

[I]ncreasing competition may gradually erode the dominant power of exchanges, which was a critical assumption underlying the old self-regulatory model. The new alternative venues for listing, while performing functions identical or very similar to those of the exchanges, often lack the financial resources and the market power to build an adequate regulatory apparatus.

Gadinis & Jackson, *supra* note 82, at 1260; see also Karmel, *Securities SROs*, *supra* note 91, at 153. Many have commented on the competing interests of the SEC to empower SROs to enforce compliance by their members, while preventing SROs from constraining competition among trading venues. See Dombalagian, *Demythologizing*, *supra* note 82, at 1091; Dombalagian, *Self and Self-Regulation*, *supra* note 14, at 328. Dombalagian added:

The Exchange Act does not specifically define the term "exchange" by reference to the potential for exercising dominant market power. Nevertheless, the Commission has acknowledged that a market's ability to restrict access or to condition access on compliance with rules restricting the activities of its members may compel exchange registration.

Dombalagian, *Demythologizing*, *supra* note 82, at 1091.

136. See Gadinis & Jackson, *supra* note 82, at 1259-60.

137. Macey & O'Hara, *supra* note 87, at 580. Macey and O'Hara wrote:

The SEC is pressuring the exchanges to engage in self-regulation. The exchanges are required to police trading on their floors aggressively—which they do not do, because they are concerned that if they are aggressive enough to satisfy the SEC, trading will migrate to other venues.

This phenomenon exhibits some of the characteristics of a "race to the bottom" or a "competition in laxity" in which competitive conditions provide incentives for exchanges to refrain from enforcing their own investor-protection rules for fear of losing market share.

*Id.*

138. Macey & O'Hara, *supra* note 87, at 576. According to Macey and O'Hara:

As with other public goods, the regulatory activities conducted by the NYSE and other exchanges are subject to significant free-rider problems. Rival trading

trading that once occurred on exchanges would move to markets with less regulation.<sup>139</sup> Efforts to maintain their members would drive the exchanges to loosen their member and market supervision programs.<sup>140</sup>

In the mid-2000s, some industry associations considered the possibility of throwing out the SRO system, with the SEC filling the void, or consolidating all SRO regulatory oversight into one SRO.<sup>141</sup> Many argued that the SEC needed to step in where it was no longer feasible to expect exchange SROs to do the job.<sup>142</sup> Commentators pointed to other important jurisdictions for securities markets that have abandoned the self-regulatory system, concluding finally that the conflicts of interest make self-regulation unworkable.<sup>143</sup>

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venues, particularly companies operating ATs and ECNs, can free-ride on these regulatory efforts, since those venues can trade NYSE—and [NASDAQ]—listed securities without incurring any regulatory costs. Individual investors and traders who transact on other markets do not pay for regulation, but they directly benefit from it. Since the NYSE and other exchanges cannot exclude rival companies from the benefits stemming from the exchanges' regulatory expenditures, they will likely underproduce regulation.

*Id.*

139. Macey & Kanda, *supra* note 83, at 1024-25 (“[I]f the NYSE alters its pricing policies in ways that harm listed firms, nonexchange members who trade the stock of such firms can simply redirect their trading volume to rival exchanges on which the shares are dually listed.”).

140. Gadinis & Jackson, *supra* note 82, at 1255-56 (“As the numbers of listing venues multiply, exchanges will be less willing to displease the issuers they fought hard to attract. Thus, exchanges might be tempted to relax their corporate governance enforcement efforts.”).

141. Sec. Indus. & Fin. Mkts. Ass’n, White Paper for the Securities Industry Association: Reinventing Self-Regulation 20-22 (Jan. 5, 2000), available at [http://archives2.sifma.org/market\\_structure/html/siawhitepaperfinal.htm#\\_Toc52859676](http://archives2.sifma.org/market_structure/html/siawhitepaperfinal.htm#_Toc52859676) (last updated Oct. 14, 2003); Rachel McTague, *In Push for Single SRO for Brokers, SIA Enunciates Its Goals, Principles*, 38 SEC. REG. & L. REP. (BNA) 162, at 162 (Jan. 30, 2006).

142. See, e.g., Dombalagian, *Self and Self-Regulation*, *supra* note 14, at 326-27; Nan S. Ellis et al., *The NYSE Response to Specialist Misconduct: An Example of the Failure of Self-Regulation*, 7 BERKELEY BUS. L.J. 102, 148-49 (2010); Macey & O’Hara, *supra* note 87, at 582-83. According to Dombalagian:

[W]ith the internationalization of investment firms, there have been parallel efforts to regulate financial responsibility on a groupwide basis rather than at the level of the individual SEC-regulated brokerage firm, and to standardize capital requirements for all firms. While SROs attempt to exercise some oversight over the corporate parents of their members, the Commission is ultimately better positioned to enter into discussions with both domestic and foreign financial services regulators to harmonize such rules.

Dombalagian, *Self and Self-Regulation*, *supra* note 14, at 326-27 (citations omitted).

143. Macey & O’Hara, *supra* note 87, at 593, 595-98, 594-95 tabl.1; see also Black, *supra* note 84, at 115 (describing opponents’ take on self-regulation as “self-serving, self-interested, lacking in sanctions, beset with free rider problems, and simply a sham”); Ellis et al., *supra* note 142, at 148.

#### IV. FINRA'S LOSS OF MARKET POWER AND WEAKENED ENFORCEMENT ABILITY

##### A. *Changes in the Brokerage Industry*

###### 1. Rise of Online Discount Brokerages and Thinning Profits

The brokerage dealer industry is in the process of contracting. The numbers of broker-dealer firms and registered representatives are falling.<sup>144</sup> The number of firms and representatives registered with FINRA has fallen since 2005.<sup>145</sup> In 2010 alone, 14,000 advisors left Wall Street, constituting a decrease of 4.1%.<sup>146</sup> Contributing factors include competitive pressure from online discount brokerages, languid trading volume during and following the financial crisis, and potential opportunities in the investment adviser space.<sup>147</sup>

Most broker-dealers make money on the commissions they charge per trade. Trading volumes are at their lowest since 2007.<sup>148</sup> The small and boutique trading firms that make up a substantial portion of FINRA's membership often generate revenues solely from commissions on individual trades and the proprietary research reports for their clients.<sup>149</sup>

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144. See, e.g., Bruce Kelly, *Why Are Small Broker-Dealers Disappearing?*, INVESTMENT NEWS (May 30, 2010), <http://www.investmentnews.com/article/20100530/REG/305309970>.

145. Since 2005, "[t]he number of FINRA-member firms has decreased by 10.4%," and "[t]he number of registered representatives has decreased by 3.8%." SEC STUDY, *supra* note 68, at 8 n.12; see also 2010: *Was the Year of the Battered Broker-Dealer*, SEC. FRAUD BLOG (Jan. 7, 2011), <http://stockmarketlawsuit.com/securitiesfraudlawyer/?p=558>.

146. *U.S. Brokerage Industry Shrinking Fast, Says Analyst*, REUTERS (Aug. 25, 2011), <http://www.reuters.com/video/2011/08/25/us-brokerage-industry-shrinking-fast-say?videoid=218694393> (displaying a video interview with Bing Waldert, Analyst, Cerulli Associates, in which he speculates on the difficult next few years for independent brokers because of expensive new regulation). A number of independent broker-dealers exited from March 2010 through February 2011. *Independent Broker-Dealer Exits: March 2010-Present*, INVESTMENT NEWS (Feb. 28, 2011, 1:05 PM), <http://www.investmentnews.com/article/20110228/chart02/110229947>.

147. See Joseph A. Giannone, *Online Brokers Are Gaining On Big Brokers: Report*, REUTERS (Dec. 1, 2010), <http://www.reuters.com/article/2010/12/01/us-onlinebrokers-idUSTRE6B06H820101201>; Joseph A. Giannone, *Tough Markets Took Toll on U.S. Brokers, Advisers in 2011*, REUTERS (Aug. 6, 2012), <http://www.reuters.com/article/2012/08/06/us-usa-brokerages-marketshare-idUSBRE8751IL20120806>; Matt Egan, *Sick of the Street, Some Financial Advisors Fly Solo*, FOX BUS. (Mar. 27, 2012), <http://www.foxbusiness.com/industries/2012/03/27/fed-up-with-wall-street-some-financial-advisors-go-independent/>.

148. Hibah Yousuf, *Trading Volume at 5-Year Low. Don't Panic.*, CNN MONEY (Aug. 22, 2012, 7:50 AM), <http://money.cnn.com/2012/08/22/investing/trading-volume/index.html>.

149. Maureen Farrell, *Which Brokerage Will Be the Next to Fall?*, CNN MONEY (Feb. 8, 2012, 9:08 AM), [http://money.cnn.com/2012/02/08/markets/brokerage\\_trading/index.htm](http://money.cnn.com/2012/02/08/markets/brokerage_trading/index.htm); Rebecca Lipman, *Brokerage Stocks: Is the Brokerage Industry on Death Watch?*, KAPITALL.COM (Feb. 9, 2012), <http://wire.kapitall.com/investment-idea/brokerage-stocks-is-the-brokerage-industry-on>

Since the mid-1970s, competition on commission rates has thinned profit margins. Discount brokerages have revolutionized the industry, charging extremely low, competitive commissions.<sup>150</sup> Services once only offered as a package began to unbundle.<sup>151</sup> Retail investors were suddenly able to open accounts with brokerages that performed only execution services and charged very low commissions in return.<sup>152</sup>

The advent of Internet discount brokerage services in the late 1990s continued to put pressure on the traditional broker-dealer model.<sup>153</sup> Even the large full service brokerages joined the Internet wave, perhaps begrudgingly, in the late nineties.<sup>154</sup> By the end of 1999, Citibank, Morgan Stanley Dean Witter, Prudential Securities, and Merrill Lynch were all offering online trading.<sup>155</sup> During the tech stock mania of a decade ago, day trading by non-professionals boomed.<sup>156</sup>

While the day trading craze of that era has ended, the online do-it-yourself platform has grown, particularly following the financial crisis.<sup>157</sup> Between 2008 and 2010, online brokers gained approximately three percentage points of market share, while the wirehouses and other brokerages lost over 5% combined.<sup>158</sup> During that same time, assets in online brokerages grew by more than a trillion dollars, rising to \$3.7 trillion, and are predicted to reach \$5 trillion by the end of 2014.<sup>159</sup>

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death-watch/ (explaining that three small but well-known firms have had to close due to this declining business—WJB Capital Group, Ticonderoga Securities, and Kaufman Brothers).

150. Chiu, *supra* note 127, at 318-19. Charles Schwab & Co. Inc. was one of the first. In 1975, the company began with \$70 a trade, an extremely low commission rate for the time. David Segal, *Day Traders 2.0: Wired, Angry and Loving It*, N.Y. TIMES, March 27, 2010, at BU1.

151. Chiu, *supra* note 127, at 318.

152. See *id.* at 318-19 (describing the “disaggregation” of broker services).

153. See Joseph Kahn, *Full-Service Brokerage Firms Seek Foothold on Line*, N.Y. TIMES, Oct. 21, 1999, at C2.

154. See *Securities Trading on the Internet: SEC Regulation of Internet Broker-Dealers and Alternative Trading Systems*, STROOCK CAPITAL MKTS. (Stroock & Stroock & Lavan LLP), Aug. 1999, at 1.

155. *Id.* Merrill Lynch, with eight million customers and 18,000 retail brokers, finally gave in and started an online trading business. *Id.*

156. See *id.*

157. Andrew Osterland, *Do-It-Yourself Model Gaining Ground on Advisers*, INVESTMENT NEWS (Feb. 26, 2012, 6:01 AM), <http://www.investmentnews.com/article/20120226/REG/302269982>.

158. *Id.* The wirehouses are estimated to have lost 1.1 percentage points and other brokerages four percentage points. *Id.*

159. *Id.* Such online brokers include Charles Schwab, Fidelity Brokerage Services LLC, TD Ameritrade Inc., and The Vanguard Group. *Id.* Although the online market still has “less than a third of the nearly \$12.5 trillion managed by financial advisors,” their share of the assets “grew at a compounded annual rate of 19%, compared with 14% in adviser channels of distribution in that two-year period.” *Id.*; see also Lavonne Kuykendall, *Cost of Advice a Key Factor for Budget-Conscious Clients*, INVESTMENT NEWS (March 18, 2012, 6:01 AM), <http://www.investmentnews.com/article/20120318/REG/303189981>.

The overwhelming majority (approximately 67%) of all U.S. households now have a direct investing account.<sup>160</sup> While only a quarter of those households use their direct accounts as their primary investment relationship, that figure is expected to grow in the future.<sup>161</sup> Internet brokerages are constantly broadening their product and service offerings “with varying levels of guidance and advice.”<sup>162</sup> Their websites offer ever-improving financial planning tools and research and increasingly provide many of the offline traditional brokerage services at reduced rates.<sup>163</sup> At least one industry analyst expects direct providers will control about \$380 billion or 10% of all retail managed accounts by 2014.<sup>164</sup>

## 2. Shift to Investment Adviser Profession

The investment adviser (“IA”) profession is growing. Between 2004 and 2010, the number of IAs registered with the SEC grew by 38.5%.<sup>165</sup> The assets under management of SEC-registered IAs grew by 58.9% over that period.<sup>166</sup> In contrast, since 2005, the amount of FINRA

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160. Osterland wrote:

It isn't just the lower end of the investor spectrum that is choosing a self-directed path. In fact, high-net-worth investors, according to Ms. Wolf, have made an even more substantial shift to self-directed investing. In 2008, a survey of 550 investors with at least \$5 million in investible assets found that 21% said their investing orientation was self-directed; 36% said they were adviser-directed. In 2011, the proportions were reversed, with 36% self-directed versus 22% adviser-directed. The survey was conducted by Cerulli and Phoenix Marketing International Inc.

Osterland, *supra* note 157.

161. *Id.* According to Osterland:

Some migration of assets to self-directed platforms is by design—at least from the wirehouses' perspective. The major Wall Street firms have been raising minimum account thresholds for their financial advisers for years in an effort to improve their productivity. Merrill Lynch Wealth Management, for one, this year lowered payouts to its advisers on accounts of less than \$250,000—in some cases, not paying anything if they have too many such accounts.

*Id.*

162. *See id.*

163. *See id.* (“Managed-account programs at some of the larger companies may even have estate attorneys on staff for consultation. In general, the fees in such programs are less than 1% of assets. ‘The offerings are pretty extensive and can replicate what traditional advisers offer.’” (quoting Cerulli Associates Inc. Associate Director Katherine Wolf)).

164. *Id.*

165. SEC STUDY, *supra* note 68, at 6 n.3. As of 2010, there were more than 11,000 IAs registered with the SEC and more than 275,000 state-registered IA representatives. *Id.* at 6. There are also 15,000 state-registered IAs. *Id.*

166. *Id.* at 6 n.3. In 2004, assets under management of registered IAs totaled \$24.1 trillion. *Id.* The IAs registered with the SEC “manage more than \$38 trillion for more than 14 million individual and institutional clients.” *Id.* at 6. This amount excludes the assets under the management of state-registered IAs. *See id.*



member firms has decreased by 10.4% and the number of registered representatives of broker-dealers has decreased by 3.8%.<sup>167</sup>

There is significant overlap between the two groups, although IAs are not subject to FINRA's jurisdiction.<sup>168</sup> As of 2010, "approximately 88% of IA representatives were also registered representatives of a FINRA registered [firm]."<sup>169</sup> However, the number of fee-only advisers grew from 29% to 66% of the market in 2010, while commission-only advisers fell from 35% to 12%.<sup>170</sup>

Many industry insiders, as well as recent business reorganizations, suggest a general shift away from the broker-dealer, commission-based model to the investment advisory, fee-based model.<sup>171</sup> At Charles

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167. *Id.* at 8 n.12. There is also a demographics problem posing "an imminent threat to the broker-dealers' future," [according to] James Roth, a managing director at Pershing, the Bank of New York Mellon correspondent clearing unit that provides record-keeping, trading products and services and financing to small brokerage and investment advisory firms." Joseph A. Giannone, *Graying Brokers: Retirement Wave Creates Talent Gap*, REUTERS (Apr. 18, 2011, 10:02 AM), <http://www.reuters.com/article/2011/04/18/brokerages-recruiting-idUSN1419145120110418>. According to large wirehouses, brokerages are finding it difficult to keep their personnel at current levels. *See id.* According to a recent consulting firm industry study, "[m]ore than a third of U.S. financial advisers will turn sixty-five over the next ten years." *Id.* The percentage of brokers fifty-five and older has been increasing for the last few decades, while the number of brokers forty-five and younger has been dropping. *Id.* Young college graduates are less and less interested. *Id.* The large wirehouses have started to change their recruiting source by now going after independent brokers, once looked down upon by the big firms. Helen Kearney, *Big Firms Look to Hire Independent Brokers*, REUTERS (May 19, 2011, 11:55 AM), <http://www.reuters.com/article/2011/05/19/us-advisers-recruiting-idUSTRE74I56220110519>.

168. *See* Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1030 (2009) (noting that since 1996, the SEC and state regulators have shared supervisory authority over IAs). Sandra Gotlaufa explained:

The Investment Advisers Act defines an investment adviser as "any person who, for compensation, engages in the business of advising others, either directly or through publications and writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities." Thus, if a client wants to purchase or sell securities, the investment adviser will provide analysis and advice; however, the adviser will not execute the transaction for the client but will instead refer the client to a broker-dealer.

Sandra Gotlaufa, Comment, *The Business of Turning Rookies into "Professional" Day-Traders: A Call for Improved Regulation of Day-Trading Training Firms*, 48 CAL. W. L. REV. 175, 205 (2011) (footnote omitted) (quoting Investment Advisers Act, 15 U.S.C. § 80b-2(a)(11) (2006 & Supp. IV 2011)).

169. SEC STUDY, *supra* note 68, at 12.

170. Mark Schoeff, Jr., *Market Volatility Represents Opportunity to Expand Advice Business: TD's Bradley*, INVESTMENT NEWS (Oct. 13, 2011, 2:10 PM), <http://www.investmentnews.com/article/20111013/FREE/111019954>.

171. *See id.* (quoting Tom Bradley, President of TD Ameritrade Institutional, discussing large-scale flow of money, resources, and opportunities from broker-dealers to registered investment advisories). One commentator has called this abandonment of the brokerage model "the largest shift in the financial services world in a hundred years." Josh Brown, *Perhaps I've Been a Bit Too Harsh...*, WALL ST. J. (Jan. 25, 2012, 2:46 PM), <http://blogs.wsj.com/financial-adviser/2012/01/25/perhaps-ive-been-a-bit-too-harsh/>; *see also* B-Ds Voice Margin Concerns Arising from

Schwab, “customers moved \$21 billion into assorted fee-based advice offerings.”<sup>172</sup> In addition to the trouble broker-dealers are facing (as discussed above) there are some industry insiders that see actual business opportunities for advisors in today’s financial services environment.<sup>173</sup> Large firms are exiting the independent broker-dealer space to focus on their wealth management offering, citing the large regulatory, technology, and human capital costs associated with the broker-dealer model.<sup>174</sup> Brokers are also taking a “hybrid” route.<sup>175</sup>

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*Congress, RIA Conversions*, FIN. ADVISOR (Jan. 24, 2012), <http://www.fa-mag.com/fa-news/9752-b-ds-voice-margin-concerns-arising-from-congress-ria-conversions.html> (“Broker-dealers at the Financial Services Institute’s OneVoice conference in Orlando shared their concerns that new regulations from Washington, coupled with the migration of advisors to the RIA business model, were acting to squeeze their firms’ profit margins.”). Broker-dealer Raymond James Financial Services CEO Dick Averitt recently “speculated that the migration of reps to the RIA space could turn out to be a long-lasting megatrend.” *Id.* Raymond James is also a corporate registered advisory firm (“RIA”), under which brokers can “dual-register as advisers or independent contractor fee-only advisors.” Brown, *supra*. Twenty-five years ago, “Raymond James’ independent contractor business was a small part of the firm’s total revenues,” but it is now the firm’s biggest business. *Id.* If the shift away from the broker-dealer model proves permanent, “Averitt noted Raymond James will have to make adjustments to maintain their profitability.” *Id.*

172. Segal, *supra* note 150.

173. See Schoeff, Jr., *supra* note 170.

174. See, e.g., Bruce Kelly, *Edelman Financial to Exit Indie-Rep Business*, INVESTMENT NEWS (Oct. 11, 2011), <http://www.investmentnews.com/article/20111011/FREE/111019975>. Edelman Financial Group (“Edelman”) managed about \$17 billion in client assets from 43 U.S. offices. Dan Jamieson, *Edelman Financial to Be Bought for \$257 Million*, INVESTMENT NEWS (Apr. 16, 2012, 1:12 PM), <http://www.investmentnews.com/article/20120416/FREE/120419954>. Edelman announced last year that it was exiting the independent-contractor brokerage business, citing severe flaws in the model and economics, as well as the independent broker-dealer space, which would affect approximately 15 practices and 75 representatives—to focus on the wealth management space. Kelly, *supra*. The hurdles in the independent broker-dealer space that he cited included “competition for advisers, regulatory demands on managing and supervising those practices, and technology demands and requirements. ‘Those all make it very difficult to manage the business successfully without scale.’” *Id.* (quoting co-CEO Ric Edelman). In April, it was announced that a private equity firm will be buying Edelman for \$257 million, well above its current stock price. Jamieson, *supra*.

175. Helen Kearney, *Advisers Take “Hybrid” Route to Independence*, REUTERS (March 16, 2011, 11:05 AM), <http://www.reuters.com/article/2011/03/16/hybrid-advisers-idUSN0926160520110316> (“Independent broker-dealers are increasingly establishing registered investment advisers for brokers experimenting with fee-based models, while custodians are offering account-integration software and introducing RIAs to independent brokers willing to house their commission business.”). RIAs hold on to their brokerage licenses for those “clients who prefer paying commissions on a transaction basis, or who cannot afford the conventional annual fee of 1 to 2 percent of assets a year charged by most individual investment advisers.” *Id.* Kearney reported that:

From 2004 to 2009, the number of registered investment advisers who held onto their Series 7 brokerage licenses almost doubled to 14,160, making hybrid the fastest growing of the seven wealth management channels tracked by consulting firm Cerulli Associates.

(The other categories are big ‘wirehouse’ brokerages, regional brokerages, insurance-owned brokerages, independent brokers and fee-only advisers.)

*Id.*; see also Kristen French, *Former Merrill Guns Launch Hybrid with International Ambitions*, WEALTHMANAGEMENT.COM (Apr. 13, 2012), <http://wealthmanagement.com/blog/former-merrill->

## B. Impact on FINRA's Deterrence and Enforcement Efforts

### 1. Expulsion Is FINRA's Most Severe Sanction

In this Section, we discuss the challenges that the loss of market power poses to FINRA's regulatory mission. The sanction of disciplinary fines is intended to deter misconduct.<sup>176</sup> The size of the fine is intended to be commensurate with the severity of particular violations.<sup>177</sup> In this way, FINRA wants the fines to outweigh the benefit to be had from misconduct.<sup>178</sup>

FINRA's rules that enable it to expel members when they fail to pay their disciplinary fines reflect the SRO's reliance on expulsion as the ultimate sanction.<sup>179</sup> As the Second Circuit noted, FINRA has always relied on its threat of expulsion from the brokerage industry to compel members to pay their disciplinary fines.<sup>180</sup> The exchanges and NASD had monopolies in major corporate stock and liquidity in the case of the exchanges and the OTC market, and then the brokerage profession, in the cases of NASD and FINRA.<sup>181</sup> As suggested earlier, Congress crafted the Exchange Act with the belief that expulsion would be an extreme economic sanction because of the SROs' market power in extremely valuable resources.<sup>182</sup> The SRO system assumes that access to those resources is more valuable than any fine the SRO system would reasonably impose.<sup>183</sup>

This system assumes that members would pay their fines because the fines would cost less than expulsion from the industry.<sup>184</sup> Today, we are likely seeing members make this calculation when they ignore FINRA's targeted requests for information.<sup>185</sup> If these individuals

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guns-launch-hybrid-international-ambitions.

176. See *An Introduction to the Principles of Morals and Legislation* (J.H. Burns & H.L.A. Hart eds.), in *THE COLLECTED WORKS OF JEREMY BENTHAM* 165 (J.H. Burns ed. 1970).

177. See *id.* at 167.

178. See *id.* at 166 (explaining that "[t]he value of the punishment must not be less in any case than what is sufficient to outweigh that of the profit of the offence"). For a robust overview of the history and strands of deterrence theory, see generally Keith N. Hylton, *Punitive Damages and the Economic Theory of Penalties*, 87 GEO. L.J. 421 (1998).

179. See *Fiero v. Fin. Indus. Reg. Auth., Inc.*, 660 F.3d 569, 574 (2d Cir. 2011) (quoting 15 U.S.C. § 78o-3(b)(7) (2006)).

180. *Id.* at 576 ("[NASD] has always relied exclusively upon its powers to revoke the registration of or deny reentry into the industry to punish members who do not comply with sanctions.").

181. See *supra* Part III.A.

182. See *supra* notes 88-90 and accompanying text.

183. See *supra* note 82 and accompanying text.

184. See *supra* notes 82, 88-90 and accompanying text.

185. See, e.g., Gregory S. Profeta, Exchange Act Release No. 34-62,055, 98 SEC Docket (CCH) 1513, 1514-15 (May 6, 2010) (dismissing application for review of FINRA's expulsion for

submitted the requested information, FINRA would have presumably detected misconduct. These individuals expect that the amount that FINRA would have fined for the misconduct would have exceeded the cost of expulsion. As such, the value of expulsion is the maximum amount FINRA can fine its members. It is the ceiling.

Because expulsion is the last sanction, once members are expelled, they have no incentive to pay their fines.<sup>186</sup> FINRA had brought the action against Fiero because Fiero, who was both fined and barred, was unwilling to pay the penalty.<sup>187</sup>

Prior to 1999, NASD, the predecessor to FINRA, routinely added fines to sanctions barring individuals and firms from the industry.<sup>188</sup> The fines were suspended until, and only became due if, an individual sought to reenter NASD and the broker-dealer industry.<sup>189</sup> In 1990, NASD announced a new policy of seeking to collect unpaid disciplinary costs and fines.<sup>190</sup> Despite its announced intent, NASD had the lowest collection rates out of several SROs from 1992 through 1996.<sup>191</sup> In 1998, the SEC began an unsuccessful program to help NASD by obtaining court orders directing barred individuals to pay their fines.<sup>192</sup> Upon the

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failing to comply with FINRA's request for information under Rules 8210 and 9552); Bill Singer, *Giving FINRA the Silent Treatment—and Getting Barred for It*, BROKE & BROKER (May 7, 2010), <http://www.brokeandbroker.com/index.php?a=blog&id=401> (cautioning against the behavior of the applicant in the Profeta SEC hearing).

186. See Gadinis & Jackson, *supra* note 82, at 1253 (noting a lack of sanctions available after the use of expulsion). Federal agencies have notorious undercollection rates for the fines they levy. See Ezra Ross & Martin Pritikin, *The Collection Gap: Underenforcement of Corporate and White-Collar Fines and Penalties*, 29 YALE L. & POL'Y REV. 453, 456-57 (2011) (reporting that although the SEC and the Commodity Futures Trading Commission "tend to do better than other federal agencies . . . they still collect less than half of the penalties offenders are ordered to pay"); see also Jean Eaglesham, *Chasing Fraud, Then Chasing Cash*, WALL ST. J., July 8, 2011, at C1 (reporting that the SEC and the Commodity Futures Trading Commission had failed to collect large amounts from fines).

187. In *Fiero*, a NASD "hearing panel expelled Fiero Brothers, barred Fiero from associating with any FINRA-member firm in any capacity, and fined the Fieros \$1,000,000 plus costs, jointly and severally." *Fiero v. Fin. Indus. Reg. Auth., Inc.*, 660 F.3d 569, 572 (2d Cir. 2011).

188. GAO REPORT, *supra* note 73, at 2.

189. See *id.* NASD imposed these fines in order to discourage firms and individuals from seeking reentry into the industry. See *id.* The fines were rarely collected because violators rarely sought reentry. *Id.*

190. *Notice to Members 90-21: Collection of Fines and Costs in Disciplinary Proceedings*, FIN. INDUSTRIAL REG. AUTHORITY (1990), [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=1304](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1304).

191. See GAO REPORT, *supra* note 73, at 2, 5. "The securities SROs included the American Stock Exchange, the Chicago Stock Exchange, the Chicago Board Options Exchange, the New York Stock Exchange, and NASD." *Id.* at 5. The other SROs were the National Futures Association and other futures SROs. *Id.*

192. *Id.* at 11. In seeking to obtain court orders on behalf of NASD, SEC said it was exercising its authority under Exchange Act § 21(e)(1). *Id.* Cases were limited to those affirmed on appeal and that met other specific requirements. *Id.* Of the cases referred to the SEC in the first two to three

recommendations of a special NASD task force created in 1998 to review its sanction and collection policies, NASD changed its sanctioning policy so that fines would only be added to sanctions barring individuals in the “most egregious cases.”<sup>193</sup>

Expelled members were no longer in demand of NASD’s service (permission to work as broker-dealers) and therefore no longer had an incentive to comply with NASD’s fine collection policy.<sup>194</sup> This lack of incentive remained once NASD became FINRA in 2007. FINRA is unable to compel compliance because it lacks mechanisms other than market power to do so.

## 2. The Cost of Expulsion from FINRA Varies

The problem with the sanctioning framework of FINRA, and the exchange SROs, is that the cost of expulsion varies, and, as a result, FINRA’s ability to exercise market power varies. The cost varies with the profitability of the brokerage profession relative to other professions, and the availability of those alternative professions. The more wealth an individual can expect to earn as a broker-dealer, the more valuable the brokerage profession is to that individual. The cost of expulsion is also reduced by the opportunity cost of not being in another profession, as well as the price FINRA charges for access to the profession, as reflected in its membership fees, ongoing regulatory fees, and the overhead for mandated internal compliance regime. Overhead is expected to increase in the next few years as new regulatory requirements impose considerable cost burdens on broker-dealers.<sup>195</sup>

Moreover, it is likely that the cost of expulsion is less costly to those who earn their income through fraudulent business activities.<sup>196</sup>

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years, the SEC had obtained court orders for eleven. *Id.* By the spring of 2001, NASD had collected fines from three of those eleven cases. *Id.* Interestingly, though, was that NASD collected some or all of the fines on four cases before the SEC obtained final court orders. *Id.*

193. *Id.* at 10. Where there was no widespread customer harm and the “serious wrongdoers had been removed from the industry,” fines need not be imposed. *Id.* NASD’s fine collection rate improved dramatically when NASD stopped its general practice of levying fines when barring individuals. *Id.* at 2. In 1997, NASD collected 25.5% of the \$38.8 million it had levied. *Id.* at 10 tbl.2. In 1998, NASD’s levied fines in closed cases amounted to \$27.9 million, of which only 39.8% was collected. *Id.* In 1999, it collected 67.4% of the \$40.3 million levied. *Id.* By 2000, the amount NASD fined had decreased to \$14.3 million, of which it collected 81.1%. *Id.* The percentages are the amount of dollars collected, not the number of firms that were fined and that paid. *Id.*

194. *See id.* at 2.

195. *See, e.g.,* Richard Roth, *How the SEC and FINRA Are in Danger of Destroying Their Own Industry*, INSIDE REG. BEAST BLOG (June 25, 2012), <http://wealthmanagement.com/blog/how-sec-and-finra-are-danger-destroying-their-own-industry> (describing how one of FINRA’s newest regulatory requirements, Rule 2111, will impose time and cost burdens on broker-dealers).

196. *Cf.* Nicholas Guiliano, *FINRA Permanently Bars Cambridge Legacy Securities*, SEC. ARB. BLOG (July 19, 2012, 4:01 PM), <http://www.securitiesarbitrations.com/Securities-Arbitration->

We therefore should further discount the cost of expulsion for FINRA violators. This is because their “skills” are easily re-deployable outside the brokerage profession.<sup>197</sup>

A former FINRA member can continue trading by opening accounts with online brokerages, such as Scottrade or TD Ameritrade.<sup>198</sup> A recent example is Garrett Bauer, who pled guilty in late 2011 to a seventeen year insider trading scheme that allegedly “netted more than \$32 million since 2006 alone.”<sup>199</sup> Both as a broker-dealer representative associated with a FINRA member, and then as a stay-at-home online trader, Bauer purchased and sold shares for himself and his tippees through his accounts at TD Ameritrade and Goldman Sachs Execution and Clearing, L.P. (“GSEC”).<sup>200</sup>

Working on his own may have even been better for him. He was no longer reliant on his bosses for a bonus, and being on his own lessened the risk of getting caught. If Bauer had been barred from FINRA for perhaps failing to keep his licensing up to date or some other rule violation unrelated to insider trading, no flags would have been raised and he could have continued his activities through his online brokerage account.<sup>201</sup>

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Blog/Article/7/2012/220/FINRA-Permanently-Bars-Cambridge-Legacy-Securities (reporting the FINRA expulsion of broker-dealer for selling \$23 million worth of private placement offerings without having reasonable basis for believing they were suitable to be offered to its customers); Ashley Lau, *Texas Broker-Dealer Expelled by FINRA Hearing Officer*, REUTERS (Apr. 25, 2012), <http://www.reuters.com/article/2012/04/25/pinnacle-finra-idUSL2E8FPD5E20120425> (discussing the FINRA expulsion of broker-dealer and its president who were found to have raised \$10 million through fraudulent sales).

197. For example, a professional stock trader can conduct trading activity privately from an apartment. Criminal Complaint at 8 *United States v. Bauer*, (Mag. No. 11-3536 (MF)), 2011 WL 1279766 (D.N.J. filed Apr. 5, 2011).

198. See, e.g., *id.* at 8, 13 (showing that a professional stock trader who traded actively in a private apartment used T.D. Ameritrade to purchase securities).

199. David S. Hilzenrath, *Go-Between in Alleged Insider Trading Pleads Guilty*, WASH. POST, Apr. 12, 2011, at A14, available at [http://www.washingtonpost.com/business/economy/middleman-pleads-guilty-in-insider-trading-scheme/2011/04/11/AFV5y9LD\\_story.html](http://www.washingtonpost.com/business/economy/middleman-pleads-guilty-in-insider-trading-scheme/2011/04/11/AFV5y9LD_story.html).

200. Since 2001, Bauer worked as a professional stock trader with three separate proprietary trading firms. Criminal Complaint, *supra* note 197, at 8. He left his last firm in 2010 and began handling all his trades from his Upper East Side apartment through his online accounts. *Id.* RBC Professional Trader Group, the proprietary trading firm Bauer was associated with from 2001 to 2008, provided its traders with trading accounts at GSEC. *Id.* at 9.

201. Federal officials had been investigating the scheme and as early as 1999, TFM Investment Group (“TFM”), a brokerage firm, sued Bauer alleging that he had non-public information when he bought options from TFM days before a 1998 deal involving Clorox. *TFM Inv. Grp. v. Bauer*, No. Civ. A. 99-840, 1999 WL 820197, at \*1 (E.D. Pa. Sept. 29, 1999). The suit was dismissed because TFM was unable to “indicate how, when, where and from whom defendant allegedly acquired the non-public, material inside information.” *Id.* at \*2; see also Hilzenrath, *supra* note 199. The insiders suspended the scheme for five years, concerned that the government was on to them. Criminal Complaint, *supra* note 197, at 10-11.

Expulsion is more costly to those in the highest-paying, most elite positions, like those held at Goldman Sachs.<sup>202</sup> Individuals expelled for Ponzi schemes and boiler room sales tactics often resurface after getting barred from FINRA. Some continue to hold themselves out as broker-dealers, orchestrating one Ponzi scheme after another.<sup>203</sup> Former broker-dealers may also have outside business interests they can pursue after getting expelled from FINRA. Several brokers expelled from the industry in the 1990s for infamous boiler room sales tactics have interestingly turned up in the jet brokerage industry.<sup>204</sup>

The decreasing profitability of the brokerage profession reduces the amounts FINRA can fine before violators opt for expulsion and compresses the range of fines FINRA can impose according to the severity of violations.<sup>205</sup> While the brokerage profession may not be as profitable, a Ponzi scheme as a broker-dealer may be very profitable.<sup>206</sup> As the brokerage profession declines in value, the relative value of misconduct in FINRA increases.

As the ceiling lowers, more misconduct will be more valuable than expulsion. A wrongdoer's calculus would also change if it were to decide *ex ante* that, because the fine likely to be imposed on it would cost as much as or more than expulsion, it would not pay the fine if caught. The expectation of being expelled for nonpayment would lead a rational wrongdoer to behave really badly—violating rules that would warrant expulsion.<sup>207</sup>

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202. See Gotlauba, *supra* note 168, at 200-02.

203. James P. Donovan, senior exec. vice president for tech. & strategy, Speech at XBRL U.S. National Conference (Nov. 18, 2009), available at <http://www.finra.org/Newsroom/Speeches/Donovan/P120400>.

204. See, e.g., *Why Are Private Jet Charter Brokers So Sleazy?*, PRIVATE FLYER (July 18, 2011, 4:27 AM), <http://privateflyer.wordpress.com/2011/07/18/why-are-private-jet-charter-brokers-so-sleazy> (describing the famous case of Al Palagonia, who was kicked out of the industry in 1998 after his firm, D.H. Blair, a boiler-room operation, was shut down). Palagonia became a jet broker and head of Halcyon (which went under after accusation of sabotage by its COO). *Id.* Palagonia is now at Apollo Jets. *Id.* Other examples include Todd Rome and Richard Sitomer who were at Millennium Securities and are now at Bluestar, as well as Manny Scarso and Adgar Alacon who are at Jet.com. *Id.*

205. See *supra* Part IV.A.

206. See Diana B. Henriques & Alex Berenson, *The 17th Floor, Where Wealth Went to Vanish*, N.Y. TIMES, Dec. 15, 2008, at A1.

207. See *An Introduction to the Principles of Morals and Legislation*, *supra* note 176, at 165; Hylton, *supra* note 178, at 468, 470-71.

## V. CONCLUSION

Optimal deterrence theory suggests that so long as FINRA's probability of detecting misconduct is less than one, a would-be offender will not be deterred unless the penalty is at least as great as the benefit to be gained by violating FINRA's rules multiplied by the probability of detection.<sup>208</sup> Private self-regulatory organizations do not have the same power that the state has to enforce its decisions. Insider traders pursued by the Department of Justice can be jailed.<sup>209</sup> Insider traders pursued by FINRA can only be fined or expelled from the industry.<sup>210</sup> In other words, optimal deterrence theory tells us that would-be offenders forgo misconduct when the value of the penalty is at least as great as the profit from the offense.<sup>211</sup> The optimal value of the penalty is also affected (inversely) by the probability that the misconduct is detected.<sup>212</sup> When the likelihood of detection is low, the penalty must be relatively high in order to deter misconduct.<sup>213</sup>

If FINRA's compliance program is weak—detecting only a small fraction of misconduct—optimal deterrence theory would suggest that FINRA must either invest in improving its monitoring capabilities or increase the penalties it imposes for misconduct, or both. However, absent help from the state to enforce its rulings, if FINRA increases penalties by making more offenses punishable by expulsion and increasing the size of the fines it imposes, FINRA risks weakening its ability to enforce monetary sanctions. Expelled members would certainly have no incentive to pay the fines that are also imposed on them.

At the same time, FINRA could only increase the size of the fines it imposes to the point that a member prefers paying a fine to being expelled. Membership in FINRA would lose value and the threat of expulsion would weaken as a tool to incentivize fine payment. A wrongdoer's calculus would also change if it were to decide *ex ante* that, because the fine likely to be imposed on it would cost as much as expulsion, it would not pay the fine if caught. As stated earlier, the

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208. See John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965, 994-95 (1984); Hylton, *supra* note 178, at 468, 470-71.

209. E.g., Peter J. Henning, *How Serious a Crime Is Insider Trading?*, N.Y. TIMES DEALBOOK (Aug. 10, 2011, 3:30 PM), <http://dealbook.nytimes.com/2011/08/10/how-serious-a-crime-is-insider-trading/>; Peter Lattman, *Galleon Chief Sentenced to 11-Year Term in Insider Case*, N.Y. TIMES DEALBOOK (Oct. 13, 2011, 9:14 PM), <http://dealbook.nytimes.com/2011/10/13/rajaratnam-is-sentenced-to-11-years/>.

210. *About FINRA*, *supra* note 1.

211. See Hylton, *supra* note 178, at 468, 470-71.

212. See *id.*

213. See *id.*



expectation of being expelled for nonpayment would lead a rational wrongdoer to behave really badly and violate rules, thus resulting in expulsion.<sup>214</sup> Therefore, FINRA's enforcement scheme requires that FINRA detect a sufficient portion of member misconduct.

One way to make expulsion more costly would be to make expulsion include disqualification from other professions. Expulsion from FINRA would disqualify individuals from a range of professions and income-producing sources. Those barred by FINRA are already subject to a statutory disqualification excluding individuals from other parts of the securities industry.<sup>215</sup> The Maloney Act authorizes FINRA to deny membership to those who have been expelled from another SRO, whether an association or exchange.<sup>216</sup> Under FINRA's By-Laws, a person subject to such a statutory disqualification "cannot become associated with or continue to be associated with any FINRA member firm unless the member firm applies to FINRA and is granted permission for [the disqualified person] to be associated with the firm."<sup>217</sup> SROs must give notice that they are willing to offer membership to someone with a statutory disqualification or to allow a

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214. This is similar to marginal deterrence concerns, which suggest "that a very harsh punishment would not discourage the offender from committing a more harmful act which carried the same, or only slightly harsher, punishment." *Id.* at 426.

215. Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(39)(A) (2006). According to the statute:

A person is subject to a 'statutory disqualification' with respect to membership or participation in, or association with a member of, a self-regulatory organization, if such person—has been and is expelled or suspended from membership or participation in, or barred or suspended from being associated with a member of, any self-regulatory organization . . . .

*Id.* See *Feins v. Am. Stock Exch., Inc.*, 81 F.3d 1215, 1218 n.1 (2d Cir. 1996) ("Statutory disqualifications include primarily prior felony convictions, willful violations of the federal securities laws, and other conduct that has, or could have, resulted in expulsion or suspension from a self-regulatory organization.").

216. 15 U.S.C. § 78o-3(g)(2). According to the statute:

A registered securities association may, and in cases in which the Commission, by order, directs as necessary or appropriate in the public interest or for the protection of investors shall, deny membership to any registered broker or dealer, and bar from becoming associated with a member any person, who is subject to a statutory disqualification.

*Id.*

217. *Mathis v. SEC*, 671 F.3d 210, 216 n.5 (2d Cir. 2012). Earlier this year, the SEC approved new FINRA restrictions on new applicants' and certain members' association with statutorily disqualified parties. Order Approving a Proposed Rule Change to Adopt FINRA Rule 1113 (Restriction Pertaining to New Member Applications) and to Amend the FINRA Rule 9520 Series (Eligibility Proceedings), Exchange Act Release No. 34-63,933 (Feb. 18, 2011), 76 Fed. Reg. 10,629, 10,629-30 (Feb. 25, 2011); Notice of Filing of Proposed Rule Change to Adopt FINRA Rule 1113 (Restriction Pertaining to New Member Applications) and to Amend the FINRA Rule 9520 Series (Eligibility Proceedings), Exchange Act Release No. 34-63,316 (Nov. 15, 2010), 75 Fed. Reg. 71,166, 71,166-67 (Nov. 22, 2010).

person with a statutory disqualification to associate with a member.<sup>218</sup> If a bar from FINRA also disqualified individuals from certain sales activities (depending on the misconduct that led to expulsion) or opening online trading accounts, FINRA's market power would be increased.

To compensate for the reduced value of the penalty of expulsion, FINRA might also want to invest in improving its detection.<sup>219</sup> In 2009, the FINRA Special Review Committee, formed by FINRA's Board of Governors, produced a report examining FINRA's examination programs, and specifically, its examinations of Bernard Madoff's and R. Allen Stanford's firms.<sup>220</sup> The Committee concluded that FINRA's jurisdiction should be expanded to include IA oversight.<sup>221</sup> Although it had inspected Madoff over the years, it was prevented from investigating the IA side of Madoff's business, which is where the fraud reportedly occurred.<sup>222</sup> Without the help of the courts or the SEC to enforce fines, FINRA's enforcement scheme requires that FINRA find ways to increase its market power or its detection capabilities.

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218. 7 FEDERAL PROCEDURE: COMMODITY AND STOCK EXCHANGES § 13:378 (2008).

219. See Hylton, *supra* note 178, at 468, 470-71.

220. SPECIAL REVIEW COMM. REPORT, *supra* note 75, at 1.

221. *Id.* at 6, 71-72; see also Ben Protess, *A Regulator Moves Postcrisis to Expand Power over Wall St.*, N.Y. TIMES DEALBOOK (Apr. 25, 2011, 6:58 PM), <http://dealbook.nytimes.com/2011/04/25/postcrisis-a-regulator-moves-to-expand-power-over-wall-st/> (quoting Richard Ketchum as saying, "We can't continue to have an environment where less than 10 percent of investment advisers are examined each year. For some relatively smaller ones, it's more than 10 years. That's not an acceptable investor protection environment"); Mark Schoeff, Jr., *IAA, FINRA Rivalry Hotting up As SRO Bill Nears*, INVESTMENT NEWS (Mar. 9, 2012, 1:52 PM), <http://www.investmentnews.com/article/20120309/FREE/120309874>.

222. SPECIAL REVIEW COMM. REPORT, *supra* note 75, at 4-5, 50-51.

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