Is Self-Regulation the Answer? Assessing the Proposal for FINRA Oversight of Investment Advisers

Ian K. Peck

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Is Self-Regulation the Answer? Assessing the Proposal for FINRA\(^1\) Oversight of Investment Advisers

by Ian K. Peck\(^2\)

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1. The Financial Industry Regulatory Authority.

2. Associate, Private Funds, Kirkland & Ellis LLP (San Francisco, CA). I am grateful to Professor David H. Webber of Boston University School of Law for his thoughtful comments and guidance on this paper. I would also like to thank Meaghan Banks and Steven Erkel and their staff at the Berkeley Business Law Journal for their excellent editorial assistance.
I. INTRODUCTION

Periods of severe economic crisis often lead to a vigorous legislative and regulatory response. The stock market crash of 1929 and Great Depression of the 1930s spurred the passing of the Securities Act of 1933, Securities Exchange Act of 1934, and the creation of the Securities and Exchange Commission (“SEC”). These actions served as a direct response by the federal government to the systemic, abusive practices that were largely responsible for this period of massive economic and social instability.

On September 15, 2008 investment banking giant Lehman Brothers filed for bankruptcy protection after taking unprecedented losses to its stock valuation and client assets. It would soon become clear that Lehman’s collapse was not an isolated event, but a symptom of what would become known as the financial crisis of 2008. Once the extent of the crisis became clear, it became equally clear that a legislative and regulatory response would not be far off.

That response came on July 21, 2010 when President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”). With sixteen separate titles, Dodd-Frank is an attempt at reforming the financial services industry, including insurance policies, regulation of banks, and Wall Street transparency and accountability.

Title IX of Dodd-Frank, entitled “Investor Protections and Improvements to the Regulation of Securities,” serves a broad array of functions including increasing investor protection, strengthening regulatory enforcement and remedies, and improving the regulation of credit rating agencies. Title IX is a direct response to at least two major market-based ills that existed in the lead-up to the financial crisis: the securitization of subprime mortgage loans and the historic Ponzi scheme perpetrated by Bernard Madoff.

Section 914 of Title IX, the focus of this Article, is perhaps typical of Dodd-Frank’s structure: instead of substantive legislation, Congress requires the SEC to act. Specifically, the SEC was tasked to: (1) “review and analyze the need for enhanced examination and enforcement resources for investment advisers” and (2) “report its findings” to Congress including “a discussion of regulatory or legislative steps that are recommended or that may be necessary

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6. Id. § 901.
7. Id. § 914.
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to address the concerns identified in the study."8

In January 2011, as required by Congress, the SEC’s Division of Investment Management issued the Section 914 Report.9 Given that I will discuss the SEC’s findings, for now it is sufficient to list the SEC’s report to Congress which aims to bolster the strength of regulatory examinations and enforcement proceedings in the investment advisory industry. The three proposals are:

(1) Imposing user fees on SEC-registered investment advisers to fund their examinations by the Office of Compliance Inspections and Examinations (“OCIE”)

(2) Authorizing one or more SROs [self-regulatory organizations] to examine, subject to SEC oversight, all SEC-registered investment advisers

(3) Authorizing FINRA to examine dual registrants for compliance with the Advisers Act10

This Article assesses the third of these legislative options by looking at the merits of the arguments for and against it, reviewing applicable legal precedent, and considering the appeal of the first two options.

The third proposal would be effective if a universal fiduciary standard were imposed. Section 913 of Dodd-Frank requires the SEC to research and report on current issues related to the legal standards that various financial services professionals are held to.11 Specifically, Congress wants to know whether there is a continued justification for holding investment advisers, but not broker-dealers, to a fiduciary standard when providing personalized investment advice to retail customers about a securities product. The outcome of this debate is inextricably linked to the issue of investment adviser oversight.

II. BACKGROUND: THE CURRENT STATE OF INVESTMENT ADVISER REGULATION AND THE SECTION 914 REPORT’S FINDINGS

There is a limited portion of investment advisers in the United States that is subject to regulation by the SEC. The Investment Advisers Act of 1940 (“Advisers Act”) the major federal statutory framework regulating investment advisers, defines an investment adviser as:

8. Id. (I will refer to the congressionally required report as the “Section 914 Report” or “914 Report”).
10. Id. at 39. (For the purposes of this paper the term “dual registrants” should be understood as a financial services firm or professional concurrently registered as a broker-dealer and Investment Adviser).
11. Dodd-Frank § 913.
[a]ny person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.\(^\text{12}\)

Over a decade ago, Congress passed the National Securities Markets Improvement Act of 1996 ("NSMIA") to alleviate the SEC’s strained resources by shifting some regulatory responsibility of investment advisers to the states.\(^\text{13}\) NSMIA generally prohibited investment advisers from registering with the SEC unless they had at least $25 million in assets under management. Section 410 of Dodd-Frank amends NSMIA by requiring SEC-registered investment advisers to oversee at least $100 million of assets under management.\(^\text{14}\)

The 914 Report reflects an increase in the amount of registered investment advisers between 2006 and 2010: 8,581 and 11,888 respectively, an increase of 38.5\%.\(^\text{15}\) During roughly the same period, Office of Compliance Inspections and Examinations staff ("OCIE"), whose job it is to examine registered investment advisers, decreased from 477 to 466 staff members.\(^\text{16}\)

A cornerstone of the 914 Report is the SEC’s analysis of the number and frequency of investment adviser examinations conducted over the past five years. The number of investment adviser examinations has decreased: 1,543 examinations occurred in 2004 while only 1,083 occurred in 2010, a growing downward trend with the exception of 2008.\(^\text{17}\) This also means that the percentage of registered investment advisers subject to examination every year declined during this same period. Eighteen percent (18\%) of investment advisers were examined in 2004 while only nine percent (9\%) were examined in 2010.\(^\text{18}\)

The SEC summarizes these trends as follows:

[\(alt\) the rate registered investment advisers were examined in 2010, the average registered adviser could expect to be examined less than once every 11 years, compared to approximately once every six years in 2004. The decrease in both the number and frequency of examinations is attributable, in part, to the growth in the number of registered investment advisers.\(^\text{12}\)]

\(^\text{12}\) 15 U.S.C. § 80b-2 (2012) (as this paper does not attempt to analyze the nuance of the Investment Adviser definition under the Advisers Act, I will let the statutory definition speak for itself).


\(^\text{14}\) Dodd-Frank § 410.

\(^\text{15}\) SEC § 914 Report, supra note 9, at 14.

\(^\text{16}\) Id. at 10. (This also meant that the ratio of the number of registered Investment Advisers to number of OCIE staff became more pronounced. It was 18 Investment Advisers per OCIE staff member in 2004 and by 2010 the ratio was 25.8:1).

\(^\text{17}\) Id. at 14.

\(^\text{18}\) Id.
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of registered investment advisers and the decline in the number of OCIE staff.\textsuperscript{19}

The Report also provides insight into the comparative level of resources dedicated to examinations, as measured by number of regulated entities (i.e. industry professionals) per examiner. In 2004, the number of entities per examiner for the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the SEC were 1.2, 1.9, and 18.0, respectively. By 2010 the number of entities per examiner for the same agencies was 0.7, 1.6 and 25.8, respectively.\textsuperscript{20} While the Report notes that the scope of examinations differs across agencies, these numbers provide a useful comparison of peer financial regulatory agencies.

Part of the reason for Section 410 of Dodd-Frank, just as NSMIA intended, is to restrict the scope of investment advisers eligible to register with the SEC (over $100 million in assets under management). States will shoulder the burden of regulating this larger population of investment advisers, allowing the SEC to focus on only the largest and perhaps most sophisticated advisory operations. The 914 Report projects that once Section 410 is enacted, the number of SEC-registered investment advisers will decline from 11,888 to 8,538.\textsuperscript{21}

Given the anticipated relief, one might very well wonder what the problem is. The SEC sees at least two. First, the SEC projects a steady increase in the number of registered investment advisers and the assets they manage. Noting that the rate of increase is “difficult to predict” the SEC anticipates an annual growth of five percent in the number of SEC-registered investment advisers.\textsuperscript{22} If true, the SEC expects the number of SEC-registered investment advisers to grow from 8,358 to 10,897 by 2016, and then to 13,908 by 2021.\textsuperscript{23} The point of this projection exercise is to demonstrate that although Section 410 is well-intentioned, it is likely to provide nothing more than short-term relief.

Second, while the passage of Section 410 would ostensibly free up OCIE’s time to do more examinations, the SEC cautions that Dodd-Frank “creates several new examination obligations for the Commission, which the Commission will have to meet by redeploying OCIE staff currently committed to existing examination programs, including the investment adviser examination program.”\textsuperscript{24} OCIE will have the added responsibility of examining municipal advisers, certain swap entities, clearing agencies, credit rating agencies, and

\begin{itemize}
  \item 19. \textit{Id.}
  \item 20. \textit{Id.} at 13.
  \item 21. \textit{Id.} at 17.
  \item 22. \textit{Id.} at 19.
  \item 23. \textit{Id.} at 19-20.
  \item 24. \textit{Id.} at 23.
\end{itemize}
FINRA. Again, while it is difficult to predict with certainty the exact impact these new responsibilities will impose, it is clear that while Section 410 takes steps to free up OCIE resources, other sections within Dodd-Frank push in the opposite direction.

Based on the figures and trends in its 914 Report, the SEC provided Congress with three options to strengthen examination and enforcement of the advisory industry. As noted above, the proposed options are:

1. Imposing user fees on SEC-registered investment advisers to fund their examinations by the Office of Compliance Inspections and Examinations (“OCIE”)
2. Authorizing one or more SROs to examine, subject to SEC oversight, all SEC-registered investment advisers
3. Authorizing FINRA to examine dual registrants for compliance with the Advisers Act.

While this paper focuses on assessing the arguments that have been made about the SEC’s three proposals (especially the third), the next section provides background on the theoretical underpinnings of the two major pieces of legislation that regulate broker-dealers and investment advisers.

III. TWO ACTS, TWO AUDIENCES

To fully appreciate the SEC’s proposals, it is not enough to weigh costs and benefits. Instead, one must consider the legal landscape that has surrounded regulation of the financial services industry for almost a century. This section will lay out the goals and major provisions of the Securities Exchange Act of 1934 (regulating broker-dealers) and the Investment Advisers Act of 1940 (regulating, as the name suggests, investment advisers), which together comprise much of this landscape.

A. The Securities Exchange Act of 1934

The Securities Exchange Act of 1934 (“Exchange Act”) is the primary source of federal legislation regulating American securities markets. The Exchange Act was the product of Congressional hearings focused on understanding the root causes of the stock market crash of 1929. While the Securities Act of 1933 (“Securities Act”) was passed a year earlier with the goal of producing transparent and time-metered public offerings to investors, the Ex-
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The Exchange Act focuses its attention on securities transactions on exchanges such as the New York Stock Exchange (“NYSE”).

The Exchange Act has been referred to as “a laundry list of problems for which Congress articulated neither the means nor the end objective.” The newly created SEC was tasked with writing specific rules aimed at combatting that laundry list of problems. One of these problems was market manipulation at the hands of broker-dealers. Commonly known as “pump-and-dump schemes,” broker-dealers would purchase a security and stimulate buy-side behavior, driving up the security’s price. Once it reached a sufficient (false) peak value, broker-dealers would quickly sell their position at a profit before the price deflated back to its pre-frenzy price. Insider trading was another major problem on Congress’s list. Because no systemic disclosure regime existed before 1933, corporate insiders were able to use nonpublic information to their trading advantage.

Thus, one of the watershed provisions of the Exchange Act, albeit a rule promulgated by the SEC, is Rule 10b-5. That rule, *inter alia*, reads:

> It shall be unlawful for any person . . .

a. To employ any device, scheme, or artifice to defraud

b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading; or

c. To engage in any act . . . which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Rule 10b-5 is a broad and powerful tool for the SEC and private parties (generally in a class action context) to combat deceptive, fraudulent, or manipulative behavior by making such activity unlawful.

Another central Exchange Act feature is the periodic reporting obligations listed in Section 13 of the Act. A publicly-traded company, whose securities are registered with the SEC, must comply with a web of reporting duties to ensure that investors and the marketplace in general have up-to-date, truthful information about company risk factors, financial position, and recent performance.

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29. *Id.* at 7.
30. *Id.* at 6.
31. *Id.*
32. *Id.*
While the Exchange Act regulates broker-dealer behavior in the realm of fraud, a bulk of conduct-based guidance comes in the form of FINRA rules. Yet FINRA, the sole self-regulatory organization (“SRO”) for the brokerage industry is tasked by the SEC with maintaining and enforcing a rules-based system of brokerage conduct both at the firm and individual level. One such FINRA rule (generally known as the “suitability standard”) requires that a broker-dealer, when recommending the purchase, sale or exchange of a security to a customer, have:

reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

The Exchange Act, supplemented by FINRA rules, reflects regulatory responses to the brokerage industry over time. By far the most prominent features of the Exchange Act, Section 10(b) and SEC Rule 10b-5, cast a wide net to deter broker-dealer fraud and deceptive practices.

B. The Investment Advisers Act of 1940

The Investment Advisers Act of 1940 (“Advisers Act”) regulates individual advisers managing client funds. The Advisers Act, like the Exchange Act, contains various provisions prohibiting fraudulent practices. However, the central theme of the Advisers Act is its imposition of a fiduciary duty on advisers with respect to their clients. SEC v. Capital Gains Research Bureau, Inc. operates as the authority on what an investment adviser’s federal fiduciary duty entails. In that case, an adviser made a practice of purchasing certain securities for his personal account just prior to making the same purchase recommendation to his customers for long-term investment. What the adviser failed to tell his customers was that he was not buying for long-term investment. Rather, once the security’s market price rose substantially, the adviser would sell his position at a tidy profit. The precise question in front of the Supreme Court was:

whether Congress . . . intended to require the Commission to establish fraud and deceit ‘in their technical sense,’ including intent to injure and actual injury to clients, or whether Congress intended

35. FINRA is the brokerage industry’s self-regulatory organization. “It was created in 2007 through the consolidation of the National Association of Securities Dealers (“NASD”) and the member regulation, enforcement and arbitration divisions of the New York Stock Exchange.” S.E.C. Section 914 Report, supra note 9, at 4.
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a broad remedial construction of the Act which would encompass nondisclosure of material facts.40

In order to resolve this question of statutory construction, the Court considered the history and purpose behind the Advisers Act, holding that the Advisers Act reflected a congressional recognition “of the delicate fiduciary nature of an investment adviser relationship”, as well as . . . to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.”41

Without fully detailing the exact fiduciary standard, the Court went on to note that prior courts have imposed on a fiduciary “[1] an affirmative duty of ‘utmost good faith[,]’ [2] full and fair disclosure of all material facts[,] [and 3] an affirmative obligation ‘to employ reasonable care to avoid misleading . . . clients.’”42

While both the Advisers Act and Exchange Act regulate the movement of securities throughout the financial system, their historical aims are quite different. First, the Exchange Act is primarily concerned with remedying broker-dealer fraud through Rule 10b-5. Broker-dealers must conform to FINRA rules that provide a rules-based approach to deterring fraudulent and unethical conduct. Importantly, the Advisers Act applies to investment advisers as fiduciaries to their customers. Instead of a standard of fraud or a rules-based approach, the Advisers Act lays down general prohibitions against conduct that would violate the sensitive nature of a fiduciary relationship. The Advisers Act looks less to intentional fraud than to conflicts of interest, even subconscious ones that could upset the fiduciary duties of loyalty and care.

It is important to consider these differences when analyzing the SEC’s proposed options in its Section 914 Report; it is also necessary to consider these differences when assessing the arguments for and against a FINRA presence in the regulation of the advisory industry. As mentioned above, it is not enough to make a reasoned decision on the proposed options without first understanding the intentions and theoretical underpinnings of both regulatory regimes. Furthermore, understanding these underpinnings can be helpful in analyzing the merits of a universal fiduciary standard. While the SEC has applied the Exchange Act and Advisers Act to separate groups, these distinctions may be less relevant considering the modern environment of financial services.

40. Id. at 280.
41. Id. at 283 (internal citation omitted).
42. Id. at 284.
IV. SHOULD FINRA REGULATE INVESTMENT ADVISERS? ARGUMENTS AND ANALYSIS

This section will assess the prominent arguments for and against the SEC’s proposed third option, which would authorize FINRA to examine investment advisers for compliance with the Advisers Act. It will also necessarily involve a look at the first two options. In addition, I will supplement each argument with my own response, offering considerations that may support or undercut a particular position. In this section, I argue what should be the most effective solution to the problem identified in the Section 914 Report. In so doing, I set forth the proposition that if a universal fiduciary standard is imposed, FINRA oversight of investment advisers is more easily justified because there would be less legal and practical distinction between advisers and broker-dealers. However, if a universal fiduciary standard is not imposed, the justification for an expanded FINRA presence becomes based almost entirely on examination frequency, a problem I believe the SEC can mitigate itself by imposing a FINRA-like user fee on its registrants.

A. Arguments in favor of option three

1. More frequent examinations

One of the most staggering findings in the Section 914 Report is the fact that, based on the SEC’s rate of investment adviser examinations in 2010, the average registered adviser could expect to be examined less than once every eleven years. It is not surprising, therefore, that one of the leading arguments in favor of FINRA gaining examination and enforcement jurisdiction over dual registrants is the notion that FINRA is capable of instituting more frequent examinations.

The SEC found that in 2008 FINRA examined 57% of its broker-dealer members while the SEC examined 14% of registered investment advisers that year. In 2009, FINRA examined 54% of its broker-dealers compared to the SEC’s 11% figure that year. The 914 Report notes that the scope and type of examinations differ, but even so, the data may point to a valuable operational efficiency within FINRA. This efficiency is due in part to the fact that FINRA is not constrained by taxpayer funding; rather, it collects obligatory annual member fees to fund its operations. This permits FINRA to scale its operations to a revenue source that, while not unlimited, does not involve congressional appropriations proceedings.

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43. For the sake of this paper, I take the SEC’s findings on the present state of its investment adviser examination program on their face.
44. SEC Section 914 Report, supra note 9, at 14.
45. Id. at 30-31.
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Three issues related to examination frequency deserve closer analysis. First, it is somewhat unclear why the SEC could not accomplish what option three envisions. In fact, in its 914 Report, the SEC’s first recommended option is to impose “user fees on SEC-registered investment advisers to fund their examinations by OCIE.”46 The 914 Report also notes that the user fee method is an approach taken by various federal agencies, such as the Office of the Comptroller of the Currency and the Nuclear Regulatory Commission, to fund their examination programs.47 While the Report did not make projections about the potential examination numbers, it is conceivable that with the freedom to scale its operations like FINRA and other federal agencies, the SEC could institute a more frequent examination program. The 914 Report also notes that an SEC-based user fee approach would save some of the tremendous resources it takes the SEC to monitor FINRA.48

Second, the examination frequency rationale of option three revolves around the size of the population of dual registrants. The SEC notes:

While dual registrants comprise a small percentage of registered investment advisers, a significant number of registered investment advisers, including many large registered investment advisers, have an affiliated broker-dealer. . . . as of October 1, 2010, there were 611 dual registrants and 2,636 registered investment advisers that had an affiliated broker-dealer. That represents 5% and 22% of all registered investment advisers, respectively.49

To start, while the SEC points to the number of investment advisers with affiliated broker-dealers, the SEC’s third option does not propose that FINRA would oversee affiliates, but proposes that it only oversee dual registrants. Therefore, to focus on the dual registrant population, which is 611 as of October 2010, the putative increase in examination frequency affects only a small percentage of the 11,888 registered investment advisers (as of 2010).50

However, included in this seemingly small population of dual registrants are some of the biggest firms in the financial services industry.51 Despite a clear numerical projection, the SEC would presumably be in a position to focus its advisory examination resources on smaller single registrants, which generally require shorter examinations. Assuming for the sake of argument that

46. Id. at 4. (In addition, the SEC does not appear to rank the desirability of its three proposed options; they merely list three options for Congress to consider).
47. Id. at 25-26.
48. Id. at 28.
49. Id. at 16 n.15.
50. Id.
51. This includes for example: Charles Schwab, Wells Fargo Investments, Chase Investment Services, Fidelity Investments, UBS Financial Services, Credit Suisse Securities, Goldman Sachs and Morgan Stanley Investment Management.
FINRA could increase its examination staff, the shift of investment adviser examination of dual registrants to FINRA would appear to mitigate the SEC’s burdened examination resources. The SEC possibly could take some of its resource savings and shift it to other needed areas such as investor education or dealing with issues of sophisticated new financial products. While the dual registrant population is just a sliver of the overall investment adviser universe, it is nonetheless a highly sophisticated and resource-draining group. All else being equal, the SEC would achieve a significant savings of its resources should FINRA take primary responsibility for dual registrant examinations.

The third consideration within the context of examination frequency is whether the SEC, despite a full capacity, is still a more effective regulator than other bodies. For example, within two years of the passage of NSMIA in 1996, the SEC handed off oversight of over 14,000 investment advisers to state securities regulators.\(^\text{52}\) With Dodd-Frank raising the federal registration asset limit to $100 million, the SEC projects that 3,350 more advisers will shift to state oversight.\(^\text{53}\) While these shifts certainly reduce the SEC’s capacity burden, they may not necessarily be a good thing for investor protection. One view is that any time the SEC can free up resources and focus its efforts on larger registrants, investors will benefit. However, this does not account for the firms with just under $100 million now under state supervision. Will investor protection suffer? Another view is that while state regulators are no less effective than the SEC, there may be concerns with the states’ own level of funding and staffing, ability to attract talent, and ability to communicate with other states.

Nonetheless, there is reason to believe that state regulators are effective and play an important role in detecting and penalizing fraudulent activity in the advisory and brokerage industries. Around 2008, securities regulators began to scrutinize auction rate securities (“ARS”). ARS, which are generally corporate or municipal bonds, were subject to changing interest rate yields through an auction usually occurring every 7 to 35 days.\(^\text{54}\) The majority of such auctions failed in 2008, causing ARS to lose significant liquidity. In one report about the ARS freeze in 2008 it was noted that:

\[\text{[r]egulators in Massachusetts and other states are not the only people investigating the way auction-rate securities are sold to investors these days. The Securities and Exchange Commission and the Financial Industry Regulatory Authority both appear to be in-}\]

\(^{52}\) SEC Section 914 Report, \textit{supra} note 9, at 18.
\(^{53}\) \textit{Id.} at 16.
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One reason given for the effectiveness of state regulators is the speed that they can respond to investor complaints. Indeed, “state regulators have a good record of fielding complaints and jumping on issues early.” Moreover, “[f]ederal officials have more resources, but are also part of very big bureaucracies with poor track records of responding quickly to financial consumers.”56 Another demonstration of state regulators’ effectiveness, albeit a self-serving one, came in the form of a 2011 report produced by NASAA to the SEC. The report, the states’ own Section 913 analysis, touts four general roles that state regulators fill: examination performance, resources, local presence in communities, and accountability.57

Regardless of the freeing up of SEC resources and nimble state regulators, there is still a risk that handing more responsibility to the states hurts advisory customers because of the challenges posed by fewer resources, communication issues between state regulators, and inconsistency between state securities laws. Interestingly, some advisory firms have recently begun to seek mergers with one another in order to remain under federal jurisdiction.58 Whatever this says of firms’ preferences, it may be true that Congress has decided to free up SEC resources to the detriment of investor protection.

2. No discernible difference between broker-dealers and investment advisers

One practically-oriented argument in support of the third option is that the services provided by broker-dealers and investment advisers have become less distinguishable. Despite offering similar services to customers, these two groups of financial professionals are subject to different legal regulatory systems, creating anomalous and inefficient oversight results.

On the topic of this phenomenon of investor perception, SEC Chairman Mary Schapiro has stated:

More and more, Americans are feeling overwhelmed by the complexity and volatility of our markets. They are looking for assis-

55. Steven Syre, The Feds Can’t Do It Alone, BOSTON GLOBE, Apr. 22, 2008, at 1F.
56. Id.
tance with their securities investments, but at times that assistance adds a host of new complexities. I am speaking of what some refer to as the broker-dealer and investment adviser divide. But it is hardly a divide. In fact rather than growing farther apart, the two industries are merging to the point of, in some cases, relative indistinguishability. 59

This finding comes in part from a 2008 RAND Institute report (“RAND Report”) commissioned by the SEC to “better understand the [financial services] industry’s dynamics and its effects on individual investors.” 60 The RAND Report assessed investors’ understanding of the financial services industry in general and the differences between broker-dealers and investment advisers specifically.

The RAND Report, through questionnaires and focus groups, found that participants tended to answer that “investment advisers and brokers are required to act in the client’s best interest” and that “brokers rather than investment advisers are required to disclose any conflicts of interest.” 61 Furthermore, the RAND Report noted that:

participants were presented with fact sheets on investment advisers and brokers. The information on the fact sheets included: definitions of broker and investment adviser, including a description of common job titles, legal duties, and typical compensation. Even after being presented with fact sheets, participants were confused by the different titles. They noted that the common job titles for investment advisers and broker-dealers are so similar that people can easily get confused over the type of professional with which they are working. Some participants said they knew which type of investment professional they have, but most did not.

The ever blurring lines between investment advisers and broker-dealers has been the subject of much debate among the SEC, financial services firms and their political supporters, and scholars of financial regulation. In fact, Section 913 of Dodd-Frank required the SEC to produce a study on the topic:

(b) STUDY—The Commission shall conduct a study to evaluate—(1) the effectiveness of existing legal or regulatory standards of care for brokers, dealers, investment advisers, persons associated with brokers or dealers, and persons associated with investment

60. RAND INSTITUTE FOR CIVIL JUSTICE, INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISERS AND BROKER-DEALERS iii (2008).
61. Id. at 109.
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advisers for providing personalized investment advice and recommendations about securities to retail customers imposed by the Commission.62

In its analysis in the Section 913 Report, the SEC came out in favor of a universal fiduciary standard when financial services professionals (be they broker-dealers or investment advisers) provide personalized investment advice to retail customers about securities products.63 Congress has given the SEC explicit authority to commence a rulemaking process instituting such a standard.64 This standard is to put substance (personalized advice about the merits of a securities purchase) over form (the title that the professional uses when providing this personalized advice).

The universal fiduciary standard debate has direct implications on FINRA oversight of investment advisers. If FINRA-regulated broker-dealers would be subject to an adviser fiduciary standard, why not come full circle and let FINRA oversee investment advisers too? Richard Ketchum, FINRA’s CEO welcomes just this possibility. While testifying in front of the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises, Ketchum stated that:

[a] fiduciary standard would establish a benchmark for the regulator and the regulated, to help ensure that brokers and investment advisers have consistent obligations through each step of their financial advice, and that the first question they must ask is not whether a product is acceptable but whether it is in the best interests of the customer.65

Whatever the merits of this debate, it is clear that should a universal fiduciary standard get the green light, this would bolster the option for FINRA oversight of investment advisers. Given that FINRA’s main broker-dealer constituency would now be subject to a fiduciary standard, FINRA examiners and lawyers would have to familiarize themselves with the Advisers Act. It would be incongruous for Congress or the SEC to take this step without giving FINRA direct oversight of dual registrants. Should the universal fiduciary standard fail, an expanded FINRA oversight makes less sense. Without the standard, the primary rational for FINRA oversight of the advisory industry would be examination frequency, which the SEC can accomplish on its own.

62. Dodd-Frank § 913(b)(1).
64. Dodd-Frank § 913(k)(1).
3. Cost effectiveness

Another leading argument for a self-regulatory approach to overseeing investment advisers is that it is more cost effective than SEC regulation. This argument is supported by the fact that FINRA’s user fee structure allows it to raise revenue independent of the appropriations process. This is a win from the perspective of efficient allocation of taxpayer dollars and can provide strong ammunition for those favoring self-regulation.

For example, in its 2008 Blueprint For a Modernized Financial Regulatory Structure, the Department of the Treasury (“Treasury”) proposed various solutions to the regulatory challenges facing the American financial system. One of those solutions was to institute self-regulation over the advisory industry “similar to that of broker-dealers.” The Treasury found that “self-regulation of the investment advisory industry should enhance investor protection and be more cost-effective than direct SEC regulation.”

However, in December 2011, the Boston Consulting Group (“BCG”) released a report entitled “Investment Adviser Oversight: Economic Analysis of Options” (“BCG Report”). BCG was hired by clients such as the Investment Adviser Association and other pro-advisory groups to “perform an independent and objective economic analysis including an estimate of the level of funding required for each of the recommended options in the SEC Section 914 Study.”

The BCG Report found that an enhanced SEC oversight program would cost between $240 to $270 million annually whereas a full FINRA SRO would cost between $540 to $610 million annually. In addition, BCG found that a non-FINRA SRO (i.e. a new SRO) would cost between $610 to $670 million annually. Interestingly, but perhaps not coincidentally, the BCG Report focuses its attention on the SEC’s first two proposed options. Those options, as noted directly above, indicate that the cost of an SRO structure would be at least double that of building up the SEC’s examination program. However, the BCG Report focuses very little attention on the 914 Report’s third recommendation. It notes that the third option’s median annual cost would be $390 million, and that estimate is without the benefit of a cost range. This fact, I believe, undermines the BCG Report’s credibility and does little to seriously analyze the third option.

Perhaps the clearest point coming out of the BCG Report is that, depending upon your perspective, the cost of the third option can be made to ap-

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67. Id.
69. Id. at 5.
70. Id.
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pear as an advantage or a disadvantage. After all, the costs of any of the three proposed options are all based on projections which may or may not be the basis for final legislative action.

4. FINRA oversight would restore trust to the financial services industry

One argument that focuses on what FINRA brings to the table is that the SEC might be incapable of investor trust and confidence. SROs are the first line of defense against industry wrongdoing. Self-regulation can also be a symbolic gesture, sending a message to investors that market integrity is a top priority.

James Koebel, for instance, argues that FINRA should become involved with advisory oversight in the wake of the Madoff scandal. He posits:

The goal of organizational reform should be to ‘set in place institutional mechanisms that will induce [potential] parties to exchange . . . [assets in market transactions]’. FINRA’s combination of expertise and enforcement capabilities would fulfill this goal and should be utilized to display to investors that the industry will hold itself accountable and can be reformed into being more trustworthy.

There is more than just wishful thinking behind Koebel’s argument. Given the importance of investor trust not only in financial markets but also in those regulating the markets, FINRA regulation would send a strong signal that the industry is working hard to regain investor trust and confidence. As Koebel notes: “[a] regulatory scheme that emphasizes SEC rather than SRO protection ‘precludes any opportunity for genuine trust and trustworthiness by ensuring that everybody acts under legal coercion.’”

While bolstering SEC oversight of the advisory industry could produce a similar examination and enforcement reality to that of FINRA, perhaps the strongest value of SRO oversight would come in the symbolism discussed above. At a time where there seems to be worldwide distrust of the financial services industry, an SRO model could be an effective way to communicate to investors that a new chapter is beginning and it starts with industry self-oversight of advisers. Although difficult to project the effect of this symbolism, certain concrete objectives could be met through FINRA that are not currently in place, namely a professional licensing system, investor access to advisor histo-


73. Id. at 92 (internal citation omitted).
tory and discipline, and micro-level rules that detect and punish bad behavior.

Before commencing employment as a broker-dealer, an individual must study for and take an examination (or examinations) that FINRA oversees and administers. For example, in order to become a standard broker-dealer (known as a General Securities Representative), one must pass the FINRA Series 7 examination. To sell securities products of investment companies, broker-dealers must also successfully complete the Series 26 examination. Another testing hurdle is the Series 24 examination, qualifying an individual to work in a supervisory capacity for a certain range of financial products. The FINRA examination regime is in place to ensure a minimum threshold of knowledge, skills, and ethical competency, much like a state bar examination for an attorney. As it currently stands, no similar examination process exists for investment advisers. If it did, this could send a significant message to investors that there is a new quality control standard in the advisory industry.

FINRA’s BrokerCheck web-based system is a tool for investors to research a broker-dealer before deciding to form a working relationship with them. A broker-dealer’s qualifications are listed to signal certain minimum professional qualifications. BrokerCheck, which is found on FINRA’s website, permits a customer to search by broker or brokerage firm. Search results include broker qualifications, registration and employment history, and disclosure of any customer disputes, disciplinary actions or other regulatory events. The same services are provided for customers of an investment adviser, which is maintained by FINRA, even if it does not have direct jurisdiction over the advisory industry.

Finally, FINRA rules attempt to prohibit specific behavior that pose potential threats to industry and customer well-being. “Selling away,” where a broker-dealer sells a securities product to a customer that is not offered or approved by the firm, has long been limited by FINRA. NASD Conduct Rule 3040—which calls this practice “private securities transactions”—requires prior written notice by a broker-dealer before engaging in any private securities transaction. Most firms require, as a matter of policy, that firm approval must be obtained before such a sale occurs. While the Advisers Act does contain some such micro-level rules, the overall thrust of the Act is less focused on the mechanics of the industry and more concerned with upholding the fiduciary framework. A vast amount of FINRA’s rules regulate the elements of the bro-

76. See NASD CONDUCT RULE 3040, PRIVATE SECURITIES TRANSACTIONS OF AN ASSOCIATED PERSON (2004).
77. See 17 CFR § 275.206(3)-2 (limiting agency cross transactions for advisory clients); see also 17 CFR § 275.206(4)-3 (limiting cash payments for client solicitations).
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In the brokerage industry in a way that is not currently achieved in the advisory industry. FINRA oversight of investment advisers, therefore, could generate a ground-level analysis and enforcement of industry practices such as conflicts of interest.

Not everyone, however, views enhanced FINRA oversight as a step in the right direction. In an open letter to the main congressional finance and banking committees, the Project on Government Oversight (“POGO”), a “non-partisan independent watchdog that champions good government reforms” outlines what it views as examples of FINRA’s ineffectiveness. First, POGO claims that FINRA failed to adequately monitor various large member firms such as Bear Stearns and Lehman Brothers, that were at the center of the financial crisis. POGO also goes out of its way to mention FINRA member firms Madoff Investment Securities and Stanford Financial Group, both having perpetrated multi-billion-dollar Ponzi schemes. However, the mention of Madoff and Stanford is misleading because their respective frauds took place in the firm’s advisory practice, over which FINRA has no current jurisdiction. If anything, the Madoff and Stanford examples cut in favor of an expanded FINRA mandate.

Second, POGO finds FINRA’s executive compensation packages to be anything but trustworthy. They note that “tax documents show than in 2008... the organization’s 20 senior executives received nearly $30 million in salaries and bonuses. FINRA’s decision to reward its senior leadership with seven-figure salaries... ought to raise serious concerns about granting the organization any additional regulatory authority.”

Finally, among other points made to Congress, POGO stated that “FINRA’s numerous failures should hardly come as a surprise given the incestuous relationship between SROs and the financial services industry.” This is a point that FINRA constantly defends itself against. Whether for or against an expanded FINRA mandate to oversee investment advisers, FINRA’s jockeying to position itself as part of the solution should not come as a surprise. Instead of carrying on with “business as usual,” FINRA can make strides to show investors that they are prepared to provide tighter safeguards across a broader range of financial services professionals.

78. Further arguments against an expanded FINRA oversight are located in sub-section B below.
81. Id.
82. Id.
B. Arguments in opposition to option three

Various arguments in opposition to the third option have already been highlighted in Section A. First, the position that FINRA would provide more frequent and cheaper oversight has been challenged by the BCG Report. Second, POGO argues that FINRA’s relationship with the financial services industry is too cozy and, if anything, Congress should consider scaling back its mandate. Finally, I made the argument that if the SEC instituted a user-fee funding method, it (as opposed to FINRA) could provide enhanced examination and enforcement oversight. Therefore, this section will be more concise and will focus on the opposition arguments yet to be discussed.

1. FINRA has insufficient experience with the advisory industry

A leading argument against FINRA oversight of the advisory industry is that FINRA does not have the requisite experience and understanding of the industry in to effectively regulate it. The following sentiments from SEC Commissioner Luis Aguilar are representative:

The SEC is the only securities regulator with the necessary experience in dealing with a principles-based regime. In fact, the SEC has administered this regime for over 70 years. No other regulator or SRO has this experience — nor is any other entity directly accountable to the public.83

David Tittsworth, Executive Director of the Investment Adviser Association, also notes that the SEC’s “expertise and experience [of the advisory industry] is critical in regulating and overseeing the profession.”84 These statements imply that FINRA, as an SRO, simply does not have the necessary level of experience to oversee the advisory industry.

While there is no doubt that the SEC is the regulatory body with significant institutional knowledge on the regulation of investment advisers, this does not mean that FINRA is inept. There are several situations where FINRA already regulates the advisory industry through the reality of dual registration.

First, FINRA’s examination program already probes into various advisory services. For example, when an examination team makes a site visit to a dual registrant, part of that examination includes an assessment of various investment advisory activities, should the firm engage in them.85

85. While this is general FINRA procedure, the specific questions are contained in confidential FINRA documents and are unavailable for direct citation in this paper.
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In addition, in 1994 the NASD Board of Governors approved the application of a NASD bylaw in a way that expanded FINRA’s review of dual registrant activities. Article III, Section 40 of the NASD bylaws mandates that prior to engaging in a private securities transaction, an associated person must “provide written notice to the member firm with which he is associated describing in detail the proposed transaction and the person’s proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction.” For example, were an investment adviser to direct a securities transaction to an associated broker-dealer, the adviser would have to follow the mandate of NASD Rule 3040, thereby leaving a paper trail for FINRA to follow up on. The leap that the 1994 Release made, however, affects where an adviser directs a securities transaction “away from their NASD member employer” and to a different brokerage service altogether. The scope of adviser transactions requiring compliance with FINRA rules increased as a result of this rule interpretation.

Another interesting avenue in which FINRA already oversees the advisory industry is with the Investment Adviser Registration Depository (“IARD”) system. According to its website, the purpose of IARD is:

[t]he IARD system collects and maintains the registration, reporting and disclosure information for Investment Advisers and their associated persons. The IARD system supports electronic filing of the revised Forms ADV and ADV-W, centralized fee and form processing, regulatory review, the annual registration renewal process, and public disclosure of Investment Adviser information.

Even though IARD is sponsored by the SEC and NASAA, FINRA was selected to develop, operate and maintain IARD because of its “regulatory business and technical expertise and the success of its Web-based licensing and regulation system, Web CRD, deployed in 1999.” While FINRA does not possess the SEC’s long-standing experience with the advisory industry, it does have a minimum competency and there appears to be no reason to believe that FINRA could not achieve full competency.

2. FINRA’s rules-based regime is incompatible with the advisory industry

A second argument against FINRA oversight of the advisory industry is the notion that FINRA’s rules-based regime for broker-dealers simply does not

86. NASD Conduct Rule 3040.
87. See NASD Conduct Rule 3040(b).
90. Id.
align with the principle-based standards to which advisers are held. While advisers are held to the vast fiduciary standard, with its facts-and-circumstances application, FINRA rules for broker-dealers apply mostly on the micro level. Consider a FINRA rule related to adjustment of customer orders:

> A member holding an open order from a customer or another broker-dealer shall, prior to executing or permitting the order to be executed, reduce, increase, or adjust the price and/or number of shares of such order by an amount equal to the dividend, payment, or distribution on the day that the security is quoted ex-dividend, ex-rights, ex-distribution, or ex-interest, except where a cash dividend or distribution is less than one cent ($0.01).91

This FINRA rule, according to proponents of the “incompatibility” argument demonstrates that the advisory industry is too diverse to absorb a realistic rules-based oversight regime. In pointed remarks to the Investment Advisers Association, Commissioner Aguilar concurred with the incompatibility problem, noting:

> It [the SEC] is the only entity with experience overseeing investment advisers, an industry governed by the Advisers Act, which is based on a principles-based regime. By contrast, broker-dealer SROs primarily regulate through the use of a very detailed, specific set of rules and are not well versed in the oversight of principles-based regulation.92

Critics of FINRA oversight of the advisory industry point to the vast differences across its members. David Tittsworth, for instance, argued that “Command and control requirements that seek to impose a one-size-fits-all solution for various legal and regulatory issues do not lend themselves to this widely divergent community of advisors.”93 A corollary of this argument is that the SEC is the appropriate regulator for investment advisers because of its flexible approach under the Advisers Act and its corresponding fiduciary duty.

These sentiments beg the question: would FINRA really be that incapable of implementing and overseeing a principle-based regime? An argument in favor of FINRA oversight is that one of its primary broker-dealer rules is arguably more of a principle than a detailed rule. FINRA Rule 2010, entitled Standards of Commercial Honor and Principles of Trade, mandates: “[a] member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.”94 The word “principle” is located

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91. See FINRA Rule 5330(a)(2010).
92. See supra note 83.
93. See supra note 84.
94. See FINRA Rule 2010 (2010).
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both in the title and the text of this rule. FINRA Rule 2010 is a common tool used by FINRA Enforcement attorneys and has been called FINRA’s “long arm” rule.95 When bringing a case against a member firm or a registered representative, FINRA Enforcement attorneys can argue that conduct or inaction violated Rule 2010. Notably, the rule has been supported by ample industry precedent.96

Yet, there seems to be a real concern that the majority of FINRA’s regulatory experience deals with smaller, clearer violations of specific rules, as opposed to a high-level determination that a broker-dealer violated general legal duties. In fact, many Rule 2010 violations are within the context of a specific activity or inaction that violates another FINRA rule or provision. While the concern about FINRA’s ineptitude with a principles-based regime may be unnecessary, FINRA would need to undergo a significant adjustment. The question is whether FINRA’s learning curve is an acceptable cost to investors, markets, and the advisory industry itself.

3. Conflicts of interest between the two industries

A third argument posits that a FINRA oversight regime in the advisory industry would result in an unacceptable conflict of interest. With whom exactly? Testifying before the Senate Committee on Banking, Housing and Urban Affairs, Professor Onnig Dombalagian noted:

As a recent D.C. Circuit decision involving the applicability of the Investment Advisers Act to broker/dealers illustrates, competition between the brokerage industry and independent financial planners and investment advisors has become increasingly tense. A broker/dealer- dominated SRO might therefore have an incentive not to adopt rules that enhance investment advisors’ obligations if by doing so broker/dealers would be precluded from offering competing investment advisory services.97


96. See Dep’t of Enforcement v. Charles Schwab & Co., Disciplinary Proceeding No. 2011029760201 (Feb. 1, 2012), where the Department of Enforcements alleged that Charles Schwab violated Rule 2010 by including a class action waiver in an updated customer agreement. The Department alleged that the waiver violated FINRA Rule 2268(d)(1), which limits a member firm’s ability to condition customer law suits. FINRA alleged that this violation also violated Rule 2010. See also Dep’t of Enforcement v. Trent Hughes, Disciplinary Proceeding No. 2008013391701, Jan. 12, 2010 (registered broker-dealer received fine and three month suspension under Rule 2010 for affixing customer signatures on cash distribution requests without member firm knowledge or consent); Dep’t of Enforcement v. Richard Bowers, Disciplinary Proceeding No. 2006003916901, Apr. 20, 2010 (member firm’s Chief Compliance Officer fined and suspended under Rule 2010 for permitting an unregistered person to act as a principal of the firm and for failing to enforce a supervisory system).

Critics fear FINRA, accustomed to understanding the nuances of the brokerage industry, would favor broker-dealers over advisors because of the established regulatory relationship. This argument is strained. While FINRA undoubtedly is attuned to the reality of the brokerage industry, it is at least conceivable that it would quickly attain a base fluency in the advisory industry. Furthermore, FINRA is overseen by the SEC, investors, and member firms. It is unlikely that FINRA would be in a position to blatantly (or even subtly) favor the brokerage industry over its counterpart. Another backstop is FINRA itself, who would understand that a potential mandate for advisory oversight is subject to continued SEC approval.

4. FINRA’s track record does not warrant more responsibility

A common argument in opposition to an expanded FINRA presence in the financial services industry is that FINRA’s track record does not merit the expansion. In Amerivet Securities, Inc. v. FINRA (“Amerivet”), a California-based broker-dealer and FINRA member firm filed suit against FINRA. Amerivet’s basis for the action is to “obtain certain books and records from [FINRA] pursuant to 8 Del. C. § 220 and the common law.” Amerivet argues that FINRA’s dismal track record warrants such an inspection. Perhaps there are discoverable conflicts, so Amerivet’s argument goes, that would explain FINRA’s allegedly poor track record. Amerivet criticizes FINRA’s track record in three focused areas: failure to regulate member firms, failure to educate the public, and excessive employee compensation.

First, the complaint states that “FINRA failed to regulate and oversee the operations of certain large member firms that are at the heart of the financial meltdown that has plagued this country.” Amerivet maintains that FINRA ignored obvious warning signs sent by these and other members. While some of the listed members, Lehman Brothers, for example, are likely mentioned because of their connection with the securitization of home mortgages, other member firms, such as Madoff Investment Securities and Stanford Financial Group, are listed in the complaint for questionable purposes. Bernard Madoff’s firm included a sizeable advisory service and a small brokerage service. Thus, it was a FINRA member firm so far as its brokerage activities were concerned. Nonetheless, Amerivet points to various examples where FINRA did not appear to stop member firms from engaging in fraudulent behavior, part of Amerivet’s reason for wishing to examine FINRA’s books and records.

98. Complaint at 1, Amerivet Secs., Inc. v. FINRA, No. 0005767-09 (Sup. Ct. D.C. 2009).
99. Id. at 3.
100. Id. (“FINRA knew or should have known about the fraud being perpetrated by several of its most influential members, but there is nothing in the public record to indicate that FINRA conducted any oversight of these now-failed malefactors or their senior executives”).
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Second, Amerivet takes issue with FINRA’s depiction of its efforts to educate investors about auction rate securities (“ARS”). Amerivet’s complaint reads:

There is no indication in the public record or on FINRA’s website that, until the collapse of the ARS market in 2008, FINRA provided any material warning or even information to the public with respect to ARS or the risks of investing therein. ….Indeed, FINRA’s executives unloaded the Company’s own funds that had been previously invested in ARS, but did nothing to warn or protect the investing public.101

This claim is perhaps a more tangible example of Amerivet’s desire to check whether FINRA did what it claims to do. The complaint notes that there are currently $165 billion in frozen ARS assets. That reality, Amerivet claims, does not appear to comport with FINRA’s version of events.

The third issue the Amerivet complaint raises is FINRA’s executive compensation structure. Amerivet frames FINRA’s executive compensation packages as “grossly excessive” and “wholly inconsistent with compensation paid to SEC and other regulators.”102 Specifically, the complaint points out former FINRA CEO Mary Schapiro’s compensation increase in 2007 from $1,999,731 to $3,140,826, despite no public record of increased responsibilities.

Each of Amerivet’s concerns with FINRA’s track record should be considered by Congress when it comes time to make a decision on the future of investment adviser oversight. While pointing to past failings runs the risk of cherry-picking unfavorable instances of FINRA inefficiencies, Congress would be well advised to consider whether FINRA paid close enough attention to its broker members caught up in trading risky mortgage-based securities products, and ARS. Executive compensation at FINRA should be monitored by the SEC and FINRA, thereby sending a clear message that its compensation structure is distinguishable from the industry that it regulates. While no oversight is ever perfect—and Amerivet is unlikely to gain access to FINRA’s books and records—the SEC and Congress can and should verify that FINRA’s claims are accurate before opening up new regulatory territory.

5. Self-regulation is no replacement for government regulation

An underlying current in the debate on a potentially expanded FINRA is whether the self-regulatory model works. In other words, can we trust the fi-
nancial services industry to police itself? A chorus of voices answers this question in the negative. One commentator puts it rather succinctly, writing: “[u]nfortunately, self-regulation stands in relation to regulation the way self-importance stands in relation to importance and self-righteousness to righteousness. It just isn’t the same thing.”103 The commentator, speaking directly about the banking system in the United Kingdom, argues that banks only ever self-regulate “cosmetically” because once a lucrative opportunity emerges, banks are unable to resist the temptation to break their self-regulatory agreements.104

Former New York Governor and State Attorney General Eliot Spitzer agrees with this proposition. He notes that:

In the absence of rigorous enforcement of rules, market players seek monopoly power and unfair advantages; they take risks at the undisclosed expense of others, or violate fiduciary duty. None of this means these actors are "evil" or "immoral." But their actions demonstrate that self-interest, unbridled by enforcement of rules, will destroy the very market so many people so ostentatiously claim to adore. So, we can now dispose of that old canard that self-regulation preserves the integrity of markets. There is essentially no evidence that any self-regulatory entity ever revealed or resolved a single structural flaw in the market place. Rather, they papered over and rationalized away all the bad behavior they witnessed.105

POGO contributed to the argument that self-regulation is no substitute for government oversight. In a response to the call for expanded FINRA oversight, POGO lists two primary reasons why the SRO model cannot be relied upon. First, there is a heightened chance that FINRA (or any SRO) will become captured by the very industry it is supposed to regulate, both because it is funded by the industry and governed by at least some industry representatives. Second, and more fundamentally, POGO points out that self-regulation is not regulation at all. Indeed, “[a]t best, self-regulation is less effective than government regulation, and at worst, it is merely an illusion meant to deflect calls for government oversight.”106

The SRO model is not a substitute for government regulation. That does


104. Id.


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not mean, however, that government regulation cannot be supported by an SRO. The issue is whether an SRO should be called upon to supplement government regulation as a series of tradeoffs. On one hand, the SEC might prefer to maintain end-to-end control over the regulation of broker-dealers and investment advisers. However, the SEC is limited by its public funding and government oversight model, and its ability to accomplish its mission is at the mercy of the current political climate. Thus, it may be a worthwhile tradeoff for an SRO such as FINRA to accomplish what government cannot. FINRA’s primary purpose is to monitor macro-level industry behavior and deter violations through enforcement. In 2011, according to FINRA, it brought 1,411 disciplinary actions, levied more than $63 million in fines and ordered more than $19 million in restitution to aggrieved investors. FINRA also notes that it barred 17 firms from the securities industry and 432 representatives from FINRA member firms, an increase from 2010’s numbers. FINRA’s activity shows that its oversight of the brokerage industry is far from illusory.

One of the tradeoffs of the SRO model is the creation of agency costs. The SEC has direct supervisory authority over FINRA, so it is not completely accurate to say that FINRA does not affect the public fisc. Yet, one benefit of an SEC/FINRA partnership is that FINRA’s industry-focused rules allow it to root out and punish bad industry practices that hurt investors. How well FINRA actually does that is at the heart of the debate about the merits of self-regulation.

V. RECOMMENDATIONS AND CONCLUSIONS

The fate of FINRA’s oversight of investment advisers is no doubt linked to the proposed universal fiduciary standard. If the standard takes effect, a FINRA presence in advisory oversight would be but a half pace away. With a universal fiduciary standard collapsing much, but not all, of the legal distinction between advisors and broker-dealers, it would be incongruous for FINRA to regulate one group but not the other. What matters most in the delivery of financial services is the nature of advice given, rather than the title of the person giving it. If a broker-dealer is in fact providing individualized investment advice to a retail customer, the SEC is correct in stating that broker-dealers should be held to the same advisor fiduciary standard.

Should a universal fiduciary standard be adopted, FINRA oversight of dually registered investment advisers might create regulatory confusion as one new fiduciary standard is implemented by two regulators (FINRA taking the dual registrants and the SEC taking single registrants). Part of this dilemma de-

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pends upon how one looks at the issue. Is the primary goal to provide a more consistent advisor examination regime or is it to harmonize the legal standards that financial services professionals are held to? If one prefers harmonization, the staggered regulatory design could be worth the administrative complexity. Staggered regulation is not unheard of; a case in point is NSMIA’s division of state and federal regulation of investment advisers. If a more consistent examination regime is the goal, FINRA’s scalability and the SEC’s newly freed-up resources could make this a reality.

If a universal fiduciary standard does not come into existence at all, FINRA oversight of dual registrants would make less sense. This is because the more compelling reason for expanded FINRA oversight is a change in the legal regime, the universal fiduciary standard, not a desire for a more consistent examination system. Without a change in the underlying law, FINRA and its supporters do not make a compelling enough case as to why it and not the SEC should be the entity to achieve higher examination rates. The most practical solution here would be to follow the SEC’s first recommendation in their Section 914 Report: that is, impose user fees on investment advisers to fund examinations by the SEC itself. This is a less drastic solution than engaging an SRO. The costs of SRO monitoring outweigh the goal of consistent examinations because the SEC could achieve consistency by itself.

The universal fiduciary issue is a guiding question when it comes to whether FINRA will obtain jurisdiction over at least part of the advisory industry. I began this paper noting that financial crises tend to stir up support for enhanced regulation: Dodd-Frank’s Sections 913 and 914 are precise examples of this. Yet, the opposite phenomenon is also true. Boom times tend to relax attitudes toward regulation and oversight, shifting societal focus and political pressure to maintaining the lucrative trends. Should the global financial system continue to pick up steam, then Congress will lose interest in acting on these issues facing the advisory industry. This would be a mistake because the underlying problem - relatively under-supervised advisors — would persist and rear its ugly head in the future. Congress should not defer the problem. If Congress, or the SEC, decide that a universal fiduciary standard is a good idea, then FINRA oversight of dual registrants makes sense. If the bifurcated legal structure separating broker-dealers and investment advisers remains, the SEC should take a page out of FINRA’s playbook and charge a user fee to fund its examinations. The SEC does not need FINRA to accomplish the goal of achieving more consistent advisor examinations.