
FINANCIAL SERVICES & E-COMMERCE

Is FINRA CONSTITUTIONAL?

By Joseph McLaughlin*

It would come as news to most Americans that large parts of our economy are regulated by two nominally private, non-profit organizations. Each of these nonprofits was created within the past few years. Each of them oversees the activities of thousands of large and small private companies and hundreds of thousands of their employees, with the power to levy ruinous fines and penalties and even to put them out of business.

One of these non-profits is famously the Public Company Accounting Oversight Board (“PCAOB”), which was the subject in June 2010 of a decision by the U.S. Supreme Court. That decision, *Free Enterprise Fund v. PCAOB*,¹ involved an attack on the constitutionality of the PCAOB for, among other things, violating the separation of powers. The parties conceded that the PCAOB was “part of the Government” and that its board members were “Officers of the United States” who exercise “significant authority pursuant to the laws of the United States.” Given those concessions, the Court held that it was a violation of the Constitution’s separation of powers for the PCAOB’s own regulator—the Securities and Exchange Commission (“SEC”), whose members are removable by the President only for cause—not to have the ability to remove PCAOB board members at will.

But there is another non-profit with clout even greater than that of the PCAOB—and that is even less accountable to the President. The Financial Industry Regulatory Authority, Inc. (“FINRA”), like the PCAOB, has expansive powers to govern an entire industry—in this case the securities industry. Federal law requires nearly all U.S. securities firms to register with FINRA, to pay substantial fees and to comply with FINRA’s rules and oversight. FINRA enforces against its “members” the federal securities laws, the SEC’s rules, and its own rules. It can issue severe sanctions, including suspension or termination of a firm’s or an individual’s registration. Unlike the PCAOB, whose assessment of fines and penalties cannot exceed \$15 million for a firm or \$750,000 for an individual, FINRA may impose monetary fines and penalties in an *unlimited* amount.

There is, of course, a strong statutory resemblance between the PCAOB and FINRA. This is because Congress,

in the Sarbanes-Oxley Act of 2002, modeled the PCAOB on the self-regulatory organizations (“SROs”) in the securities industry—which at the time included principally the New York Stock Exchange (“NYSE”) and FINRA’s predecessor the National Association of Securities Dealers, Inc. (“NASD”). But there is also a major difference between the PCAOB and FINRA (which assumed the NYSE’s regulatory functions in 2007). This difference is that the SEC appoints the members of the PCAOB board while the members of the FINRA board are either appointed by the board or elected by FINRA’s members.

Understandably, the plaintiffs in *Free Enterprise Fund* and at least one supporting *amicus*² chose not to call into question the constitutionality of the long-established SROs, emphasizing their “private” nature in contrast to that of the congressionally-created PCAOB. On the other hand, the PCAOB’s defenders chose to emphasize the SEC’s “pervasive control” over both the SROs and the PCAOB as a basis for the constitutionality of each type of organization.

The Court chose not to make an issue of the SROs where the parties had not done so, and it accepted the proposition that the PCAOB was modeled on “private self-regulatory organizations in the securities industry—such as the New York Stock Exchange—that investigate and discipline their own members subject to Commission oversight.”³ It also accepted the proposition that “[u]nlike the self-regulatory organizations, . . . the Board is a Government-created, Government-appointed entity, with expansive powers to govern an entire industry.”⁴

The folks at FINRA must have read these words and breathed a sigh of relief. And one might indeed conclude from the Court’s words that it was not troubled by the separation of powers implications of the “private self-regulatory organizations.” But the status of the SROs was not before the Court, and the parties did not address—and the Court was not asked to consider—how these organizations have evolved since the adoption of the relevant legislation in the 1930s.

Decline of Self-Regulation and Its Ultimate Spin-Off from the Trading Markets.

The Securities Exchange Act of 1934 (“1934 Act”) required securities firms to register with the SEC if they met the statutory definitions of “broker” or “dealer” and effected transactions otherwise than on a national securities exchange (such as the NYSE). On the other hand, it left it to the NYSE and the other exchanges to regulate their member firms. It was not until the Maloney Act’s invention in 1938 of the “national securities association” that a non-voluntary self-regulatory structure was developed for the over-the-counter (“OTC”) market. The NASD became a national securities association in 1939. FINRA, the NASD’s successor, is still the only significant national securities association.

In the 1934 Act, Congress had given the SEC the power to begin the end of the NYSE as a “private club,” but this power

* Joseph McLaughlin is a partner in the New York office of Sidley Austin LLP. His practice areas include: public and private U.S. and international securities offerings; U.S. disclosure obligations of public companies; U.S. broker-dealer regulation, including SEC and SRO rules relating to electronic communication, research, financial responsibility, securities credit, short sales, manipulation, misuse of nonpublic information, compliance and supervisory obligations, and activities of offshore broker-dealers.

He is the co-author (with Charles J. Johnson, Jr.) of *Corporate Finance and the Securities Laws* (4th ed. 2006, supp. 2010).

Reproduced with permission from *Securities Regulation & Law Report*, 43 SRLR 681 (Mar. 28, 2011). Copyright 2011 by The Bureau of National Affairs, Inc. (800-372-1033) <<http://www.bna.com>>

was greatly expanded by the 1975 amendments to the 1934 Act. These amendments gave the SEC the power not only to approve every new or changed SRO rule but also to require any SRO to adopt any rule the SEC deemed necessary. The amendments also required the boards of the exchanges and the NASD to have members from outside the securities industry.

For most of the rest of the 20th century, a member firm of an exchange was principally regulated by that exchange, while firms that were not members of exchanges were principally regulated by the NASD. One of the advantages often claimed for “self-regulation” was that participants in a given securities market had a large stake in preserving the integrity of that market and were also likely to be well-informed about the workings of that market. Indeed, a former SEC commissioner has described the NASD’s self-regulatory model in nearly bucolic terms:

Initially, the NASD was a nationwide voluntary organization of broker-dealers engaged in trading over-the-counter (“OTC”) stocks. Its membership was nationwide, large and diverse. Its emphasis was on self-regulation and discipline by members, as distinguished from regulation by a hired staff, and in promoting voluntary compliance with ethical standards. Principles emanating from the [1934] Exchange Act and guiding the NASD were democratic organization, business persons’ judgment and local autonomy.⁵

In the aftermath of a trading scandal, however, the OTC market’s trading and regulatory functions were separated in 1996. The NASD’s board was required to consist of a majority of non-industry members, and regulatory and disciplinary authority passed from decentralized business conduct committees to a full-time hired staff. FINRA eventually replaced NASD as the industry regulator, and the OTC trading function became a national securities exchange (Nasdaq) under the auspices of a publicly-traded company (The NASDAQ OMX Group, Inc.).

Meanwhile, with the merger in 2006 of NYSE Group, Inc. and Archipelago Holdings, Inc., NYSE membership was no longer linked to trading privileges. With the NYSE itself becoming part of a publicly-traded company (NYSE Euronext) and delegating its regulatory responsibilities to FINRA in 2007 (as have many other exchanges), the separation of the securities industry’s regulatory function from its trading functions was nearly complete.⁶

FINRA was thus established as the most important national regulator (other than the SEC) of the securities industry in all its complexity, with authority to enforce all the provisions of the 1934 Act and the SEC’s related rules, but without any of the connections to industry professionals and trading markets that had previously been thought to provide the traditional benefits of “self-regulation.”

Is FINRA Still an “SRO” as Conceived by the Court?

As many have observed, there is not much “self” in the SROs any longer. It was therefore misleading in the *Free Enterprise Fund* litigation to appeal to the “SRO model” as a justification for the PCAOB structure. The “SRO model” no longer exists.

As noted above, the Court in *Free Enterprise Fund* accepted the distinction between the PCAOB and the SROs on the basis that (1) the SROs are “private” and neither “Government-created [nor] Government-appointed,” (2) the PCAOB has “expansive powers to govern an entire industry,” and (3) the SROs in fact exercise “self-regulatory” authority, investigating and disciplining “their own members.”

But does FINRA, as it currently operates, correspond to the Court’s assumptions about “self-regulation”?

A. Is FINRA “Private” and Neither “Government-Created” Nor “Government-Appointed”?

FINRA is a Delaware non-stock corporation with antecedents as far back as the Investment Bankers Association of America in 1936. Unlike the PCAOB, which Congress in Sarbanes-Oxley created as a “body corporate” with the powers of a District of Columbia nonprofit corporation, FINRA is constituted by a Delaware certificate of incorporation. From a strictly formal point of view, therefore, FINRA is a “private” organization that is not “Government-created.”

FINRA is also not “Government-appointed” since the SEC does not appoint the members of FINRA’s board as it does the members of the PCAOB’s board.

On the other hand, FINRA derives its extensive authority from Section 15A of the 1934 Act (added in 1938 by the Maloney Act), which contemplated the creation of private groups to be recognized by the SEC as national securities associations. FINRA’s powers are based on the SEC’s recognition of FINRA as a national securities association. Thus armed, FINRA may adopt rules to prevent fraud and manipulation, to promote “just and equitable principles of trade,” and to subject its “members” to fines, penalties, suspension, and expulsion for any violation of the 1934 Act, the SEC’s rules, or FINRA’s rules. FINRA can thus be said to be “exercising significant authority pursuant to the laws of the United States” within the meaning of Article II, § 2, clause 2 of the Constitution,⁷ an activity that is not typical of “private” organizations that are not “Government-created” or “Government-appointed.”

B. Does FINRA Have “Expansive Powers to Govern An Entire Industry”?

Prior to 1983, a securities firm that did not engage in underwriting activity or that confined its business to the floor of a single exchange could choose not to become a member of the NASD and to be regulated directly by the SEC. Congress eliminated this option in 1983 except for firms doing business on the floor of a single exchange. The result was that, while the SEC continued to exercise direct regulatory authority over securities firms, it could rely on the NASD (and later FINRA) as a first line of defense. Indeed, the SEC over the years delegated entirely to FINRA the SEC’s statutory responsibility for registering new broker-dealers.

According to FINRA’s website, it oversees approximately 4600 brokerage firms, 163,000 branch offices, and 630,000 registered securities representatives. By contrast, the PCAOB had recently registered approximately 1400 U.S. accounting firms and 900 from other countries.

FINRA's revenues in 2009 were more than \$1 billion, including nearly \$50 million in fines (which FINRA does not classify as "operating revenues"). The PCAOB's revenues in 2009 were \$157 million, less than one-sixth of FINRA's revenues.

FINRA has approximately 3000 employees. The PCAOB has just over 600.

In fact, FINRA's revenues are about equal to the SEC's current budget authorization, and FINRA has nearly as many employees as the SEC.

It would appear beyond dispute that FINRA, at least as much as the PCAOB and perhaps as much as the SEC, has "expansive powers to govern an entire industry."⁸

C. Does FINRA Exercise "Self-Regulatory Authority" over Its "Own Members"?

The Court's reference to the NYSE's "investigat[ing] and disciplin[ing] [its] own members" is a throwback to the years when self-regulation meant that market participants, having by definition the greatest interest in the integrity of their market and also the greatest knowledge about its workings, could be the most effective regulators. And the "members" subject to self-regulation were "seat" holders, "member firms," "allied members," "floor brokers," "\$2 brokers," and others who were subject to NYSE discipline because they had so elected.

There is no longer anything elective about FINRA "membership," and as discussed above its regulatory functions have nearly completely passed from member-run business conduct committees to a full-time hired staff. Indeed, it is hard to escape the conclusion that FINRA clings to the notion of "membership" less because of the formalities of Delaware non-stock corporations than to preserve the fiction that FINRA is a membership organization like the local golf club.

The facts are that, far from being "members" of FINRA comparable to the former owners of seats on the NYSE and their associates, securities firms are today the functional equivalent of regulated entities with little or no input into FINRA's regulatory policy or corporate governance.⁹

Does FINRA Exercise "Executive Authority"?

Much of the scholarly constitutional analysis of the securities industry's SROs has been devoted to whether they—or, under our current circumstances, FINRA alone—should be classified as public entities or state actors that are subject to self-incrimination and due process limitations in investigations and disciplinary proceedings against securities firms or their employees.¹⁰

But the question presented by *Free Enterprise Fund* is whether FINRA exercises "executive Power" within the meaning of the Constitution. If it does, then *Free Enterprise Fund* inevitably leads to the conclusion that FINRA is unconstitutional because the President's ability to control FINRA is even less than that deemed insufficient in *Free Enterprise Fund*.

There is no question but that FINRA, even more so than the PCAOB, exercises investigative and prosecutorial functions. These functions relate not only to FINRA's own rules but also to the provisions of the 1934 Act and the SEC's antifraud,

anti-manipulation, and record-keeping rules. In 2010, FINRA filed approximately 1300 new disciplinary actions, barring nearly 300 individuals, suspending more than 400 others, and expelling 14 firms. It levied approximately \$45 million in fines and ordered more than \$8 million in restitution—and 2010 was a "down" year compared to the preceding three years.

FINRA also conducted more than 2600 routine examinations and more than 6600 "for cause" examinations. By contrast, the PCAOB conducted fewer than 400 inspections in 2009 and initiated only thirteen formal investigations.

There is also no question but that such functions are clearly within the "executive Power." The cases leave no doubt on this question. The Court in *Morrison v. Olson* so found, upholding the Independent Prosecutor statute only because the Attorney General retained the power to remove an independent counsel for good cause. "There is no real dispute that the functions performed by the independent counsel are 'executive' in the sense that they are law enforcement functions that typically have been undertaken by officials within the Executive Branch."¹¹ By contrast, the PCAOB was found wanting in *Free Enterprise Fund* because its exercise of executive power was constrained only by the SEC's ability to remove its members for cause, a "second layer of tenure protection" that impermissibly undermined the President's constitutional authority.¹²

It is no answer that many of FINRA's investigations and disciplinary proceedings relate to violations of FINRA rules and do not explicitly involve violations of the federal securities laws or the SEC's rules. First, although FINRA's consolidated rulebook is already comprehensive enough to enable FINRA to cast as a rule violation nearly every imaginable violation of the federal securities laws or the SEC's rules, the fact remains that FINRA is obligated by statute to enforce the latter against its members. Second, the PCAOB is also obligated by statute to enforce its rules as well as the applicable federal securities laws and SEC rules.

The PCAOB's defenders in *Free Enterprise Fund* relied upon the SEC's broad power over the PCAOB as sufficient to preserve the principle of presidential control, albeit indirect control. The Court responded that "[b]road power over Board functions is not equivalent to the power to remove Board members." It added:

Even if Commission power over Board activities could substitute for authority over its members, we would still reject respondents' premise that the Commission's power in this regard is plenary. . . . [T]he Board is empowered to take significant enforcement actions, and does so largely independently of the Commission. . . . Its powers are, of course, subject to some latent Commission control. . . . But the [Sarbanes-Oxley] Act nowhere gives the Commission effective power to start, stop, or alter individual Board investigations, executive activities typically carried out by officials within the Executive Branch.¹³

The SEC's power to review FINRA sanctions is equal to its power to review PCAOB sanctions, but its formal power to influence FINRA policy is *less* than what the Court in *Free Enterprise Fund* found to be constitutionally insufficient in

respect of its power to influence PCAOB policy. This is because the SEC does not have the ability to remove FINRA board members—even for cause.

It will not do to say that the SEC should not be able to remove FINRA board members because it has no role in their appointment. That argument proves too much. First of all, we do not know what role the SEC or its staff plays in reviewing proposed nominations to the FINRA board. Second, it may be that FINRA’s structure violates not only the separation of powers but also the Appointments Clause since FINRA’s board members are collectively just as much “inferior officers” as the PCAOB’s board members and whose appointment should therefore be vested in the SEC. Third, the emphasis under *Free Enterprise Fund* has to be whether the President has the ability to control executive action, and that ability can only be achieved for separation of powers purposes by removal authority exercised directly or through an officer whom the President can remove at will.

It should be noted that FINRA cannot cure its separation of powers deficiencies by deciding to grant additional due process and other constitutional protections to the firms and individuals that become the subjects of its investigations and disciplinary proceedings. That might cure deficiencies arising from its being characterized as a part of the government or a state actor, but it cannot cure a separation of powers violation.

That said, many of FINRA’s functions may not be subject to separation of powers objections. Like the Municipal Securities Rulemaking Board (whose rules FINRA enforces), FINRA should be able to continue to register firms and their representatives and adopt rules regarding their conduct. Also, like other SROs, FINRA should be able to enforce business conduct rules of an ethical nature.

A simple non-legislative solution to FINRA’s separation of powers problem would be for the SEC to require FINRA to adopt a by-law that gives the SEC the power to remove FINRA board members at will.¹⁴

Congress could also simply fold FINRA into the SEC. This is an unlikely scenario, since Congress will be reluctant to increase the federal budget by more than \$1 billion. Also, folding FINRA into the SEC would require finding a “home” for FINRA’s investment portfolio, which amounted to \$1.4 billion at the end of 2009. The first solution might, and the second solution surely would, lead to the result that securities firms and individuals would clearly be entitled to due process and other constitutional protections in future FINRA investigations and disciplinary proceedings. That would be a small price for FINRA to pay for constitutional certainty.

Endnotes

1 *Free Enterprise Fund et al. v. Public Company Accounting Oversight Board*, 130 S.Ct. 3138 (08-861) (June 28, 2010).

2 Brief of *Amici Curiae* Law Professors in Support of Petitioners 23-31 (August 3, 2009).

3 *Free Enterprise Fund*, 130 S.Ct. at 3147.

4 *Id.*

5 Roberta Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?* 14 STAN. J. L. BUS. & FIN. 151, 161 (2008) (footnotes omitted).

6 Of course, many specialized exchanges and clearing agencies continue to have supervisory and disciplinary authority over their members with respect to members’ conduct or activities related to the particular exchange or market.

7 *Buckley v. Valeo*, 424 U.S. 1, 126 (1976) (*per curiam*).

8 In addition, FINRA has urged the SEC to seek legislation that would permit the SEC to establish one or more SROs for the nation’s thousands of investment advisers. According to press reports, FINRA is interested in taking on this function.

9 By-law amendments must receive the approval of a majority of FINRA’s members (as well as the SEC’s approval), but only the FINRA board may propose by-law amendments.

10 *See, e.g.*, Roberta Karmel, *supra* note 5.

11 *Morrison v. Olson*, 487 U.S. 654, 691 (1988).

12 *Free Enterprise Fund*, 130 S.Ct. at 3154.

13 *Id.* at 3158-59.

14 The author offers no views on whether such a by-law would be consistent with Delaware law.

